

1967

Motive, Intent, and Purpose in Federal Income Taxation

Walter J. Blum

Follow this and additional works at: https://chicagounbound.uchicago.edu/journal_articles



Part of the [Law Commons](#)

Recommended Citation

Walter J. Blum, "Motive, Intent, and Purpose in Federal Income Taxation," 34 University of Chicago Law Review 485 (1967).

This Article is brought to you for free and open access by the Faculty Scholarship at Chicago Unbound. It has been accepted for inclusion in Journal Articles by an authorized administrator of Chicago Unbound. For more information, please contact unbound@law.uchicago.edu.

Motive, Intent, and Purpose in Federal Income Taxation

Walter J. Blum

Under our federal income tax many of the substantive rules for classifying actions have long appeared to call for an inquiry into somebody's state of mind.¹ Associated with these rules are the terms motive, intent, and purpose, which are by now old standbys in taxation. But despite our extensive and varied experiences with these concepts, several recent manifestations of confusion and discontent over their use in tax rules have appeared. The tax administrators are unhappy with the "primary purpose" test for determining when the cost of education is deductible as a business expense, and have proposed to substitute in the regulations a radically different type of standard.² A thoughtful commentator has written that in ascertaining when the transportation costs of a combined business-pleasure trip are deductible as business expenses, the "primary purpose" test is inferior to a formula approach that would allocate such costs between time actually spent in pursuit of business and time given over to pleasure on the trip.³ The United States Supreme Court, despite strong urgings on behalf of the tax administrators, has refused to substitute motive for intent in stating the test for delineating tax-free gifts from taxable payments of a business nature, saying: "We must confess to some skepticism as to whether such a verbal mutation would be of any practical consequence."⁴ And a court of appeals last year added its gloss to state of mind in taxation by noting that "The word purpose carries with it not only the taxpayer's

Walter J. Blum, Professor of Law, the University of Chicago, received an A.B. degree in 1939 and a J.D. degree in 1941 from the University of Chicago. Law school seminar papers by Lewis M. Collens, Stephen K. Huber, and Mark R. Ordower were useful in preparing part of this article.

¹ "It is clear that something which lawyers call state of mind, the very existence of which is denied by many respectable psychologists, is regarded as an integral part of the law." Hutchins and Slesinger, *Some Observations On the Law of Evidence—State of Mind to Prove an Act*, 38 YALE L.J. 283, 291 (1929).

² Proposed Treas. Reg. § 1.162-5, 31 Fed. Reg. 12843 (1966).

³ Klein, *Deductibility of Transportation Expenses of a Combination Business and Pleasure Trip—A Conceptual Analysis*, 18 STAN. L. REV. 1099 (1966).

⁴ *Commissioner v. Duberstein*, 363 U.S. 278, 286 (1960).

intent, but also his motive for entering into the transaction.”⁵ With these selections as rough indicators of what may lie ahead on the tax scene, a broad exploratory look at the role of state of mind in tax rules seems to be timely.⁶

I

The classic analysis of motive, intent, and purpose in criminal law provides a useful point of departure.⁷ In the traditional classroom case we are told that the defendant aimed a pistol at a person he wished to hit with a bullet; that he pulled the trigger; and that the bullet hit a bystander who was in the line of fire, while the man marked as the target went unharmed. It might be possible in this situation to distinguish three aspects of the defendant's state of mind. We might ask

⁵ *Knetsch v. United States*, 348 F.2d 932, 936 (Ct. Cl. 1965).

⁶ This piece is concerned with substantive rules of tax law and not with rules prescribing penalties for failure to comply with obligations imposed on taxpayers. It obviously does not deal with many of the substantive areas of tax law in which motive, intent, or purpose is relevant. The choice of illustrations was dictated not by their practical importance, but by their potential for contributing to the overall analysis.

Sections of the Internal Revenue Code of 1954 that might appear to refer to state of mind include the following: § 214(a) (“the purpose”); § 269(a) (“the principal purpose”); § 306(b)(4) (“one of its principal purposes”); § 341(b)(1) (“with a view to”); § 355(a)(1)(D) (ii) (“one of its principal purposes”); § 357(b)(1) (“the principal purpose” and “not a bona fide business purpose”); § 367 (“one of its principal purposes”); § 532 (“the purpose”); § 552(b) (“the purpose”); § 704(b)(2) (“the principal purpose”); § 706(b) (“a business purpose”); § 1101(d) (“one of the principal purposes”); § 1492(2) (“one of its principal purposes”); § 1551 (“not a major purpose”).

Sections of the Treasury Regulations that might appear to refer to state of mind include the following: § 1.117-3(2) (“grantor is motivated by family or philanthropic considerations”); § 1.118-1 (“contributions . . . for the purpose of”); § 1.162-5 (“undertaken primarily for the purpose of”); § 1.162-11 (“acquired for business purposes”); § 1.162-15(b) (“made with a reasonable expectation”); § 1.165-3(c)(2) (“with the intention of”); § 1.212-1(b) (“with the expectation of”); § 1.212-1(c) (“carried on primarily as”); § 1.214-1(a) (“for the purpose of”); § 1.274-2(c)(3)(i) (“expectation of deriving”); § 1.274-5(b)(3)(iv) (“expected to be derived”); § 1.871-2(b) (“determined by his intentions”); § 1.1237-1(a)(3) (“his intention”).

⁷ The classic criminal law analysis is found in Cook, *Act, Intention and Motive in the Criminal Law*, 26 YALE L.J. 645 (1917). Cook distinguishes between the terms “intent” and “intention”: One intends the desired results or the necessary consequences of a deliberate act; intention is the desire to bring about those results or consequences.

Wigmore commented that: “[T]he important aspect of Intent [or design or plan] is chiefly not an evidentiary one at all, but one of substantive law, as a state of mind accompanying the act in question and necessary to its legal effect. Occasionally, to be sure, Intent has an evidentiary significance, as where an intent at an earlier time is used to indicate the continuance of the same intent at a later time, but here the evidentiary use is to prove another mental state or condition, and not an act.” 1 WIGMORE, EVIDENCE 536 (3d ed. 1940).

The distinction between intent and intention does not seem useful in connection with most of the matters discussed in the text. In the tax field the problem generally is not proving the commission of an act. The major exception is where tax law accepts relationships determined under non-tax law, and proving the commission of an act is part of establishing such relationships.

what the defendant sought to accomplish in his act of pointing and firing the gun—that is, what was his purpose? In the illustrative case, his stated purpose was to hit the marked man. We might also inquire whether the defendant desired to harm the victim—that is, what was his intent? In the illustrative case the answer might depend on a physical fact. If perforating the bystander was not absolutely necessary in order to hit the marked man, there is no reason to conclude that the defendant intended to harm the victim; but if the marked man could not have been hit without perforation of the bystander, the defendant must have intended to harm the victim. We might also inquire why the defendant wanted to hit the marked man—that is, what was his motive? In the classroom case the motive is not given, but we can imagine as a possibility that the defendant thought the marked man was about to shoot him and was trying to protect himself by shooting first, or that the defendant had a grudge against the marked man because both were interested in the same woman.⁸

Delineating these various aspects of state of mind is worthwhile only if the distinctions make a difference in applying rules of law. In invoking criminal sanctions, we often do differentiate between the intentional and the accidental harming of a victim; and where harm is intentionally inflicted, we often do distinguish between acceptable and unacceptable motives. Moreover, determining the purpose of the act frequently can aid in establishing whether the harm was intended or unintended and in fixing the actor's motive. Thus, in the classroom case, the harm suffered by the victim probably would be regarded as intended if the defendant's purpose in pulling the trigger was to hit somebody who was standing immediately behind the victim, and that harm probably would be regarded as accidental if the defendant was trying to hit somebody standing beside the victim. Similarly, the finding as to motive might differ depending on whether the person the defendant tried to hit was a rival suitor or a stranger brandishing a gun. It is only because the substantive rules of criminal law at times require focusing on these three different aspects of an actor's state of mind that we try to maintain their separateness.⁹

⁸ The experience of the criminal law with intent has been far from satisfactory: "The Model Penal Code in its attempt to codify the concept of intent substitutes the term 'purposely' which is defined as the equivalent of 'intentionally' or 'with intent.' The purposive act, says the Model Code, must involve a material element of the offense and it must be the actor's 'conscious object to engage in conduct of that nature or to cause such a result.' . . . [I]f the material element involves 'attendant circumstances' the act is purposive if the actor 'is aware of the existence of such circumstances or he believes or hopes that they exist.' This is scarcely a clarification . . ." Marshall, *Relation of the Unconscious to Intention*, 52 VA. L. REV. 1256, 1257-58 (1966).

⁹ In the field of tort law it sometimes is useful to distinguish between motive and intent. Motive, in the sense of mental conditions in back of a desire to accomplish

In turning to income tax law, the threshold question is whether a parallel set of distinctions is required, or whether we can safely use motive, intent, and purpose as loose synonyms without sacrificing clarity.¹⁰ The threefold division seems capable of being superimposed on situations involving tax consequences. Consider the case of a Chicago-based taxpayer who flies to Miami in mid-winter, attends a series of business meetings with business associates based in Miami, then spends several days reading novels on the beach after learning that a transportation strike prevents him from leaving Miami, and finally flies home to Chicago at the end of the strike. In reviewing the taxpayer's state of mind pertaining to his trip, it could be said that his purpose in going to Miami was to attend a business meeting, that in going he did not intend to spend time relaxing on the beach, and that his motive in meeting with his associates in Miami was not revealed but conceivably could have been to advance his business career or to get away from his wife for a few days. What is important, however, is not whether such an analysis is possible, but whether it contributes to the resolution of tax problems. Exploration of that question requires analysis of particular tax rules.

The most promising area for analysis is the definition of "gift" under the income tax provision excluding a gift from the recipient's gross income. In the much discussed case of *Commissioner v. Duberstein*,¹¹ one businessman made a present of a Cadillac to another businessman.

something, cannot be relevant in the case of an unintentional or negligent tort because we cannot conceive of someone having reasons for doing that which he does not desire to do. In many tort cases intent is relevant irrespective of the actor's motive, the question being whether the actor sought to accomplish his act, even though he had no desire to inflict injury. See *Vosburg v. Putney*, 80 Wis. 523, 50 N.W. 403 (1891). In other situations, such as actions interfering with economic relationships, motive is significant in that intentional conduct which would otherwise be actionable is non-actionable if undertaken for an acceptable reason.

For two durable analyses of the role of intent and motive in tort law, see Ames, *How Far an Act May be a Tort Because of the Wrongful Motive of the Actor*, 18 HARV. L. REV. 411 (1905); Terry, *Intent to Defraud*, 25 YALE L.J. 87 (1915). That role is much more akin to the role of intent and motive in the criminal law than in tax law.

¹⁰ In the course of commenting upon the Supreme Court's handling of § 8(a)(3) of the National Labor Relations Act, Professor Bernard Meltzer observes: "[T]he Court has indiscriminately used 'intent,' 'purpose,' and 'motive,' with resultant confusion." Meltzer, *The Lockout Cases*, 1965 SUP. CT. REV. 87, 93 n.23.

Tax consequences sometimes depend on whether the taxpayer acted in good faith in not complying with some provision of the law. Such a rule fits somewhat uneasily under the state of mind rubrics noted in the text. The good faith test asks whether the taxpayer fell short because of an oversight, poor advice, or a willingness to gamble that his method of handling things would not be discovered or controverted. The question then is of the "why did he do it?" variety, and in this sense it can be assimilated within the loose meanings usually attached to motive, intent, or purpose.

¹¹ 363 U.S. 278 (1960).

The two men apparently knew each other personally and talked together frequently over the telephone as they transacted business on behalf of their respective companies. In the course of their conversations, the transferee of the auto from time to time provided the transferor with the names of potential customers for products handled by the transferor's but not by the transferee's company. The tax question was whether the recipient was to be treated as having received taxable income or an excluded gift.¹²

In presenting the issue to the Supreme Court, the government's brief attempted to distinguish between intent and motive by giving the terms their classical criminal law meaning: "Having decided to make the payment, all the payor then 'intends' is to make the payment, and if he thinks of it in his own mind as a 'gift' or as 'compensation,' he can do so only by, wittingly or unwittingly, attributing to it his own legal classification."¹³ Since an intention to make the payment is consistent with both a gift and a non-gift classification, the crucial state of mind question, the government argued, must be whether personal feelings or business considerations prompted the payment—and these are matters that go to motive. The taxpayer argued that motive was irrelevant: "A gift is a transfer of something of value 'for nothing,'"¹⁴ and the only issue is the presence or absence of "donative intent"—an intent that exists where the payor does not expect to receive anything of value in return.

There is perhaps much to be learned from the facts that this clash of positions did not produce any enlightening judicial discussion of motive versus intent in taxation, and that in deciding the case the Supreme Court by and large treated the two terms as interchangeable. The drawback in the government's position was that, while it called for distinguishing between motive and intent, it left virtually no role for the latter in the type of controversy under consideration. In the criminal law a single case may raise both the question of whether harm from deliberate conduct was accidental or intended, and the question of what motivated the conduct. In the business gift situation, however, everyone concedes that all consequences of the taxpayer's deliberate conduct, other than the legal consequences, were intended and were not accidental. On this account there appears to be no need to consider intent as separate from motive.

But in these business gift cases do we not have to deal with intent

12 INT. REV. CODE OF 1954, § 102, excludes gifts from gross income.

13 Petition for Writ of Certiorari, p. 13, *Commissioner v. Duberstein*, 363 U.S. 278 (1960).

14 Brief for the Respondents on Writ of Certiorari, p. 17, *Commissioner v. Duberstein*, 363 U.S. 278 (1960).

in the form of "donative intent," a concept that seems to differ from motive? Donative intent has played a major role under property law in distinguishing gifts from other classes of transfers. Take, for example, the situation in which a wealthy man transfers a bearer bond to his sister and receives nothing of monetary value in return. If the sister later asserts that she received a gift while the brother asserts that she is merely holding the bond subject to his call, the key inquiry is likely to focus on what the brother thought he was doing in making the transfer: Did he think that he was giving up all his rights in the bond and placing them unqualifiedly in his sister? Or did he think that he was merely putting the bond in her hands for safekeeping until such time as he requested its return?¹⁵ A version of this issue can arise in an income tax context in that the determination of who is taxable on interest yielded by the bond depends on whether there was a gift to the sister or whether the bond continued to be owned by the brother. The fact is that in determining legal relationships our tax law generally does accept all relevant non-tax law concepts, including whatever state of mind ingredients they contain, whenever no tax policy is impaired by so doing.¹⁶ Under this policy the selection of the person to be charged with income from the bond turns on state property law, and therefore "donative intent" is bound to be central in settling the tax question.

The business gift type of case, however, is of a different nature. It does not involve a disagreement between the transferor and transferee over whether the transfer is a gift under state law; everyone, we can assume, agrees that it is. The question presented is whether the income tax is to have a different definition of gift to effectuate whatever is thought to be the policy behind the exclusion of gifts from income. And once it has been decided that a different definition is called for—a step taken long ago—the concept of "donative intent" is no longer salient in defining an excludable gift. The residual issue is under what circumstances should a transfer that satisfies the "donative intent" test be treated as being something other than a gift.¹⁷

¹⁵ See William Black, 24 CCH Tax Ct. Mem. 1394 (1965).

¹⁶ Tax law tries to answer certain questions in the same way that private law would answer them if they arose under private law. Consider a lease calling for a security deposit to be applied to rent at the end of the term if no default occurs and containing an option to purchase and apply the security deposit to the purchase price. Are the payments in the form of the deposit to be classed as rents or purchase price? The Tax Court in one case answered by saying: "[H]ere we think they were . . . primarily intended as rent, and that the applicability upon purchase price is so secondary as not to require a different conclusion [T]he option was the less important consideration" *Gilken Corp.*, 10 T.C. 445, 454-55 (1948).

¹⁷ It might be noted that in the course of defining a gift under the federal gift tax, the Supreme Court had this to say: "Had Congress taxed 'gifts' *simpliciter*, it would

Very likely we have here an explanation of why the government in *Duberstein* stressed the distinction between motive and intent, even though under its argument intent was not in dispute. When the central issue is phrased in terms of intent, there is always the possibility that the donative intent of the transferor will be viewed as a significant pro-gift factor.¹⁸ By seeking to phrase the issue in terms of motive, the government apparently hoped to neutralize the element of "donative intent" and to concentrate attention on why the transferor made a transfer with respect to which he neither received any payment nor created nor discharged any legal obligation.

In the same vein, the government probably wished to nullify the persuasiveness of any statement by the transferor that he intended to make a gift. If the definition of gift is stated in terms of intent rather than motive, it is easier to fall into the error of assuming that the colloquial usage of gift comes within the technical tax definition of the term. A transferor is not very likely to say that "my motive was to make a gift"; and perhaps the oddity of speaking in this way would provide an added warning that the definition of gift is itself in issue.

A more troublesome aspect of the government's position regarding motive and intent in the definition of a gift was flagged by a point made in the taxpayer's brief in *Duberstein*: "[I]f one man hated another so much that he decided to give him \$100,000, knowing that he would drink himself to death, there would nevertheless be a gift. . . . [T]he motive would be one of hate. The same \$100,000 gift could be made by one friend to another and the motive would be for love or friendship."¹⁹ In effect, the taxpayer was arguing that the definition of gift should be hinged to intent rather than to motive because motive concerns emotions, and emotions have no place in classifying actions under the income tax. This is a challenge that is not to be ignored.

be appropriate to assume that the term was used in its colloquial sense, and a search for 'donative intent' would be indicated. But Congress intended to use the term 'gifts' [for gift-tax purposes] in its broadest and most comprehensive sense. . . . Congress chose not to require an ascertainment of what too often is an elusive state of mind. For purposes of the gift tax it not only dispensed with the test of 'donative intent.' It formulated a much more workable external test" *Commissioner v. Wemyss*, 324 U.S. 303, 306 (1945).

¹⁸ The thrust of accepted usage with respect to motive and intent in gift situations can be illustrated in a slightly different manner. Suppose that a transfer had all the outward trappings of a gift in the colloquial sense and that the transferor made expressions usually associated with gifts (again in the colloquial sense). Would it not be awkward to conclude that the transferor did not intend to make a gift because his dominant reason for benefiting the recipient was to reward him for past and hoped-for future business favors?

¹⁹ Brief for the Respondents on Writ of Certiorari, p. 10, *Commissioner v. Duberstein*, 363 U.S. 278 (1960).

The heart of the problem in business gift cases is that the transfers take place in a mixed context of economic dealings and of friendship or admiration between the parties.²⁰ In giving the present, the transferor may have had in mind the personal side of his relationship with the transferee as well as past or possible future commercial aspects of their association. The main definitional question ultimately comes down to how large a degree of the commercial element is compatible with a gift under the income tax exclusion.²¹ In administering the dichotomy between noncommercial and commercial thoughts, there is no need to draw a distinction between hate and love and other emotions. A present to a friend with whom the giver has no economic relations carries no commercial overtones, regardless of whether it is motivated by love or hate; and a present to an employee very likely has such overtones, regardless of which of these emotions the employer may experience. Stated somewhat differently, the only relevant motives are those that bear on the commercial-noncommercial dichotomy. This viewpoint probably was implicit in the government's emphasis on motive in *Duberstein*, and traces of it can be found in the efforts of the Supreme Court to discuss the problem of defining a gift in terms of intent rather than motive.

The taxpayer's point about love and hate might suggest that in business gift cases we should consider not why the transferor wanted to augment the recipient's wealth, but what he sought to accomplish in so doing. That is, assigning these terms their classic criminal law meanings, we should shift attention from motive to purpose. It is hard to see how such a change would improve handling of the problem. In the criminal law, as noted, there sometimes is need to differentiate between motive and purpose. To use a variation of the classic example, if it is found that the defendant's purpose in firing the gun was to wound the victim, our disposition of his case may depend on whether his motive was to eliminate a man he hated or to defend himself against an immediate threat posed by someone with whom he was not even

²⁰ For an illustration of the comparable problem in distinguishing between a charitable gift and a payment to charity for past or anticipated benefits from the charitable organization, see *Citizens & Southern Nat'l Bank v. United States*, 243 F. Supp. 900 (W.D.S.C. 1965); Harold De Jung, 36 T.C. 896 (1961). Where a taxpayer pays a non-exempt organization to provide services or goods to an exempt organization, there is the analogous question whether the reason for the action was to benefit the exempt organization or to benefit the non-exempt one. See *Mozelle C. Kluss*, 46 T.C. 572 (1966).

²¹ This states the definitional issue too narrowly for transfers outside the business area. For example, a transfer to a complete stranger can be a gift, provided that, in the words of the Supreme Court in *Duberstein*, it proceeds from "a detached and disinterested generosity . . . out of affection, respect, admiration, charity or like impulses." 363 U.S. at 285.

acquainted. But in applying the commercial-noncommercial dichotomy in the gift cases, the state of mind search seems to deal with precisely the same mental processes whether the issue is posed in terms of motive or purpose. Can there be any difference between asking: What commercial and what noncommercial goals did the transferor seek to accomplish? and asking: What emotions or thoughts connected with such goals activated him? Both phrasings seem to advance us equally far in determining the degree to which the transfer is to be explained by commercial as compared to noncommercial considerations. It needs only to be added that usage very likely stands against talking about purpose in the gift area—perhaps because we usually do not concern ourselves with what the donor seeks to accomplish in the case of the typical gift that has no commercial implications. Although we could view the ordinary donor in a noncommercial setting as seeking to achieve personal satisfactions, we customarily tend to think of him as giving up something rather than as pursuing a purpose.

This parallelism between motive and purpose in the business gift area can be extended to include intent. So long as the inquiry is directed at how much the transferor's conduct is to be explained by commercial and how much by noncommercial reasons, it matters little whether we refer to his motive or his intent or his purpose.²² In all probability, this was understood by the Supreme Court in *Duberstein* when, in refusing to rephrase the gift criterion in terms of motive rather than intent,²³ it said: "We take it that the proper criterion . . .

²² Compare the analysis offered by Randolph Paul: "Much confusion in tax cases has been caused by the fact that many courts and writers cheerfully use the terms 'intent' and 'motive' as though the two words were exactly interchangeable in meaning 'Intent' may be used in at least three distinct legal meanings. It may designate simply the exercise of will power necessary to cause muscular or physical movement. This concept is, of course, irrelevant in the field of tax law. Secondly, it may denote the immediate result desired by the actor. Thirdly, it may signify the ultimate reason for aiming at that immediate objective. At this point, however, intent shades into motive, which is really the ulterior intent or the cause of the intent. Intent, in other words, is the object of the act; motive, in turn, is the object or spring of the intent. Using the terms in these senses, intent is frequently material to tax questions; whereas motive—properly enough—is of importance only in comparatively rare instances" Paul, *Motive and Intent in Federal Tax Law*, in *SELECTED STUDIES IN FEDERAL TAXATION* 257-58 (2d ser. 1938).

A current comment on motive, intent, and purpose in the tax field is that: "The distinction between motive, intent, and purpose, although not entirely clear, is made less clear by the failure of the Service and the courts to attempt to make such distinctions. In general terms: purpose is what you intend to do (object); motive is why you do it; and intent is the voluntariness behind the act by which you seek to accomplish your purpose. . . ." Eliasberg, *What is Behind the Current IRS Attacks on Subsidiaries of Exempt Organizations?* 26 J. TAXATION 234, 235 n.8 (1967).

²³ Another possible explanation for the Supreme Court's refusal to substitute motive for intent is that the Court was apprehensive that revenue officials might try to upset

is one that inquires what the basic reason for his conduct was in fact—the dominant reason that explains his action in making the transfer. Further than that we do not think it profitable to go.”²⁴

In general, these observations are also valid with respect to classifying expenses as business or as personal, a problem illustrated by the fares paid by the hypothetical Chicago-based businessman who travelled to Miami and back. If the classification question is made to turn on whether his reasons for taking the trip were business or personal in nature, the issue can be posed with equal clarity in terms of motive, intent, or purpose. More precise usage, however, is likely to advance the analysis in some situations. Suppose we are uncertain why the businessman took the trip, and to resolve that doubt, we look closely at his activities in Miami. It then may be important to know which of these actions were the results of an unforeseen condition—such as his inability to return to Chicago on schedule because of an airline strike. The main issue of why he took the trip is more readily kept separate from the subordinate issue of what he planned on doing while away if the term intent is used only in connection with the latter and the terms motive and purpose are reserved for the former. This somewhat special usage of intent in fact goes beyond situations that involve both issues. In referring to what actions were planned or were foreseeable, as distinguished from being “inadvertent,” we generally speak in taxation about the actor’s intent rather than his motive or purpose.

While these last two terms may be equally serviceable for addressing ourselves to whether the actor was pursuing business or personal aims,

the status of many types of transfers which have long been regarded as excluded gifts. An example is a gift to a close relative made mainly or exclusively to avoid estate tax. This threat would not be serious once the courts straightened out which motives were and were not relevant in classifying transfers under the exclusion for gifts.

²⁴ 363 U.S. 278, 286 (1960). Note the oddity that it is the recipient who has treated the transfer as a gift on his return, and who must, if the gift treatment is put into issue, show that the transferor’s dominant reason was associated with friendship or affection rather than commerce. The relevance of the transferee’s state of mind in the definition of a gift for income tax purposes is somewhat puzzling. In *Duberstein*, the Tax Court said: “[T]he intention of the donor is of particular importance, although the recipient’s understanding of the nature of the payment is also relevant.” 17 CCH Tax Ct. Mem. 16 (1958).

At the time of the *Duberstein* litigation, transferors in business gift situations often faced the issue of whether their presents were deductible ordinary and necessary business expenses or non-deductible personal expenditures (or business expenses that failed to qualify as ordinary and necessary). Subsequent legislation limiting deduction of business gifts to \$25 a year for each donee has radically altered the posture of affairs and, it might be added, radically reduced the number of substantial business gifts. See INT. REV. CODE OF 1954, § 274(b)(1).

Scholarships and fellowships are another area in which the transferor’s reasons for making the transfer are central to a determination of the transferee’s tax position. See INT. REV. CODE OF 1954, § 117.

we here usually talk in terms of purpose and seldom in terms of motive. Why this usage has developed is not clear, but there are indications it is connected with the thought, frequently voiced in earlier times, that taxation should never be concerned with motives. The thrust of that cliché is simple. If the tax law prescribes that certain tax consequences attach to specified actions, there seems to be no need to inquire whether a person had those consequences or some non-tax considerations in mind when he acted.²⁵ As the Supreme Court said in the famous case of *Gregory v. Helvering*:²⁶ "[T]he motive of the taxpayer . . . to escape payment of a tax will not alter the result or make unlawful what the statute allows." But, as will be seen, the old cliché becomes misleading whenever the tax rule bases classification of conduct on the actor's state of mind or incorporates the notion that some acceptable goal other than the mere saving of taxes is a prerequisite to obtaining a certain advantageous classification.²⁷

A more instructive, although more conjectural, explanation of the emphasis on purpose is that our usages have given it a variety of meanings and have ringed it with a greater degree of ambiguity, and this very looseness makes it more serviceable.²⁸

²⁵ Another illustration of the point is found in connection with disregarding corporate entities. A corporation is not to be disregarded if it actually engages in business. But what if it is set up in accordance with a plan calling for it to engage in business activity at some not-too-indefinite time in the future? In *Jackson v. Commissioner*, 233 F.2d 289, 290 n.1 (2d Cir. 1956), the court observed: "When there is such an intention, but the intended business functioning does not become effective, the corporation is not to be disregarded in the interval before it becomes evident that the corporation will not so function."

²⁶ 293 U.S. 465, 468-69 (1935). In analyzing the Supreme Court's opinion in the *Gregory* case, Judge Learned Hand on different occasions spoke in terms of motive, intent, and purpose, and he seemingly thought there were differences in the contents of these terms. In *Chisholm v. Commissioner*, 79 F.2d 14, 15 (2d Cir. 1935), he said: "[The Supreme Court] was solicitous to reaffirm the doctrine that a man's motive to avoid taxation will not establish his liability if the transaction does not do so without it. . . . The question always is whether the transaction under scrutiny is in fact what it appears to be in form: a marriage may be a joke; a contract may be intended only to deceive others; an agreement may have a collateral defeasance. In such cases the transaction as a whole is different from its appearance. True, it is always the intent that controls; and we need not for this occasion press the difference between intent and purpose. We may assume that purpose may be the touchstone, but the purpose which counts is one which defeats or contradicts the apparent transaction, not the purpose to escape taxation which the apparent, but not the whole, transaction would realize." In *Commissioner v. National Carbide Corp.*, 167 F.2d 304, 306 (2d Cir. 1948), he observed of the *Gregory* opinion: "[I]t was the purpose for which the taxpayer created the corporation that determined the event; for it is not the presence of an accompanying motive to escape taxation that is ever decisive, but the absence of any motive which brings the corporation within the group of those enterprises which the word ordinarily includes."

²⁷ See Part IV *infra*.

²⁸ In *Bazley v. Commissioner*, 331 U.S. 737, 742-43 (1947), the Supreme Court distinguished between motive and purpose as follows: "One does not have to pursue the

II

Where purpose is relevant under a particular tax rule, one might jump to the conclusion that the tax consequences of a certain course of action somehow depend on the state of mind of the actor—that the rule is concerned with the relationship between act and actor. Our system is not that tidy: the term purpose is repeatedly used apart from rules embodying a state of mind test. The roles assigned to purpose are best seen after delineating various general types of rules for classifying actions. Five rough categories seem to be appropriate: (1) The classification of the action rests on ascertaining the actor's state of mind. (2) The classification ignores the state of mind of the particular actor and considers what would be the state of mind of an average or typical person under similar circumstances. (3) The classification of the action turns on its actual outcome or aftermath. (4) The action is to be classified by judging whether it is more closely associated with one activity or another, or more closely fits one function as compared to others. (5) The rule conclusively prescribes a classification based on the mere occurrence of the act.²⁹

A highly oversimplified example might be helpful in blocking out these categories. Our income tax has in general adopted the policy that

motives behind actions, even in the more ascertainable forms of purpose, to find . . . that the whole arrangement took this form instead [of another] . . . because the latter undoubtedly would have [resulted in] . . . taxable income."

²⁹ A so-called "net-effect" test may be regarded as a type of conclusory rule. The difference in thrust between a net-effect type of rule and a comparative relatedness rule is sharply illustrated by our experience with determining whether a redemption of shares is substantially equivalent to a dividend or is a disposition of part or all of a shareholder's investment. (See INT. REV. CODE OF 1954, § 302(b)(1)). In *Ballenger v. United States*, 301 F.2d 192, 196-97 (4th Cir. 1962), the court put the difference between the two types of rules as follows:

"[T]wo lines of decisions appear. The first applies a strict 'net-effect' test. Under this test, the court must hypothesize a situation where the corporation did not redeem any stock, but instead declared a dividend for the same amount. The court must then examine the situation after the dividend and compare it with the actual facts of the case when stock was redeemed, viewed always from the shareholders' vantage point. The redemption is equivalent to a dividend if the results from the hypothetical dividend and the actual stock redemption are essentially the same. . . . [I]t becomes apparent that every pro-rata redemption will be equivalent to a dividend, for in no way can it result in any alteration in the relationship of the shareholders, both with respect to their share of the distribution in question and in respect to future control and profits

"The second line of cases is not the direct antithesis of the first. All these cases adopt the 'net-effect' test, but add a further consideration—whether or not there are legitimate business purposes for the redemption. . . . Under this approach a pro-rata redemption of stock can have a business justification sufficient to overcome its resemblance to a dividend under the 'net-effect' test. The result in any case would depend to a large extent on the weight to be given the business purposes"

See the discussion in Part IV *infra* regarding business purpose.

the cost of education is deductible in computing taxable income if the training is connected with better equipping the taxpayer to carry out the work of his present profession or employment, but not if it is connected with learning a new trade or profession. This policy could be implemented by a rule falling into any of the five categories.³⁰ Consider, as an illustration, the possibilities for dealing with the case of a practicing public accountant who pays his way through law school and eventually gets a degree in law.³¹ We might cast a rule in terms of his state of mind: Did he go to law school with the thought of improving his skill as an accountant, or did he do so with the thought of becoming a lawyer? Or we might frame the rule in terms of some hypothetical "average" person's state of mind: In the circumstances under which the taxpayer went to law school, would an average person have been trying to improve his competence as an accountant, or would he have been trying to become a lawyer? Or we might work up a rule which looked to the aftermath of the action: Did the taxpayer after finishing law school actually continue in the accounting profession, or did he switch to being a lawyer? Or the rule could direct attention to the relatedness seen between accounting work and law school training, as compared to the relatedness seen between law school training and other activities: Is undergraduate law training more closely related to preparation for accounting work or to preparation for practicing law? Or the rule could simply provide that undergraduate training for

³⁰ In *Ramon M. Greenberg*, 45 T.C. 480 (1966), a case involving the expenses of a psychiatrist for psychoanalytic training, the majority, holding against the taxpayer, noted: "[W]e do not find any place in his testimony where he says [that improving his skills as a psychiatrist] . . . was his primary reason Nowhere in his testimony does he say that he does not intend to practice psychoanalysis when he graduates from the institute." *Id.* at 482. A concurring judge said he could not "agree that the existence of a plan or intention on the part of the taxpayer to practice as a psychoanalyst has any bearing on the conclusion whatsoever [because] . . . the expense of acquiring the new skill is personal in nature." *Id.* at 483. A dissenting opinion argued that primary purpose was controlling and that the taxpayer's testimony to the effect that he took the training for the help it would give him in the field of psychiatry was "not only believable and uncontradicted but also realistic." *Id.* at 485. Another dissent argued that the majority was relying on an earlier case that had mistakenly "substituted result for primary purpose." *Id.* at 487.

³¹ A certified public accountant succeeded in deducting tuition for attending law school in *Walter T. Charlton*, 23 CCH Tax Ct. Mem. 420 (1964); *Frank Kilgannon*, 24 CCH Tax Ct. Mem. 619 (1965). A certified public accountant failed to get a deduction for the expenses of attending law school in *Anthony E. Spitaleri*, 32 T.C. 988 (1959); *Huene v. United States*, 247 F. Supp. 564 (S.D.N.Y. 1965). In *Welsh v. United States*, 329 F.2d 145 (6th Cir. 1964), an Internal Revenue Service agent was permitted to deduct law school expenses even though he left government employment and entered private practice after becoming a member of the bar. See also *Milton L. Schultz*, 23 CCH Tax Ct. Mem. 1372 (1964).

a degree in law, because it almost always equips a student to perform in a field for which he was not previously qualified, is never deductible. The only open question here would be: Was the taxpayer attending law school as an undergraduate in a degree program?

We are now ready to consider in what sense the term "purpose" may be employed in the case of rules that are not concerned with the state of mind of the actor himself. It is convenient to start with classification of action based on the state of mind of a hypothetical person. The meaning of purpose—or, for that matter, of motive or intent—would seem to be the same whether the rule calls for a judgment about the actor's state of mind or about that of a hypothetical person under similar circumstances. In theory, there is, of course, a difference between the two tests. It lies in the point that, although the typical person test requires that all of the circumstances surrounding the act be considered in drawing an inference about purpose, idiosyncratic or eccentric thought patterns of the actor are to be ignored. In the illustrative case of the accountant who went to law school, a probe for the particular taxpayer's state of mind conceivably might attach considerable weight to highly personal testimony, such as, for example, that the actor never expected to practice law because he hated everything his father stood for and his father was a lawyer. It is hardly likely, even in this psychologically oriented age, that this kind of a mental fix would be imputed to a representative accountant.

In practice, the difference between the two tests is apt to be of less significance than the theory might suggest. Any judgment about an actor's state of mind, of course, must rest on inferences drawn from statements and external events which seem to shed some light on his thoughts. The process is obviously full of pitfalls. Not only may recollections and recollections be corrupted by possible tax consequences, but the very thoughts that did enter the actor's consciousness may have been spawned or refined by an awareness of tax considerations.³² The temptation to minimize taxes is often perceived as being so great that in searching for the actor's state of mind, we refuse to pay much attention to anything short of overpowering evidence of aberrations or eccentricities. Even though the father hating accountant may have

32 "The lawyer, satisfied with *a priori* reasoning and dialectics, gives more credence to an admission of evil intent than to a profession of good intent because the former is against the interest of the declarant. The psychologist, on the other hand, cannot trust a person's declarations as to what his own intentions are, or what they have been. Empirically, we know little about intention. The best that psychology can do is to apply empirical knowledge of related psychological phenomena (e.g., motivation, wishing, choice, chance) to the problem of intention." Marshall, *Relation of the Unconscious to Intention*, 52 VA. L. REV. 1256, 1257 (1966).

sworn that he was not going to follow in his sire's footsteps, we may well be reluctant to let him deduct law school tuition solely because of the evidence he presents on that score. The strong possibility that the personal idiosyncrasy was manufactured or exaggerated, consciously or otherwise, in the light of tax awareness tends to draw the hypothetical and actual state of mind tests closer together. This tendency doubtless gains reinforcement from the fact that we are naturally disposed to infer the state of mind of someone else—whether of an actual or hypothetical person—by engaging in introspection. That process probably blurs much of whatever is left of the distinction that exists in principle between the two types of tests. Nevertheless, there remain cases where the force of the taxpayer's presentation convinces us that his thoughts were not those of the average man.

A broad sampling of cases and administrative pronouncements under our income tax indicates that, as they are expressed, the rules embodying a state of mind test almost always seem to refer to the thoughts of a particular actor. The fact is that statements of the rules do not contain an explicit reference to a typical taxpayer—thus leaving the impression that it is the thoughts of the particular individual which count. But not too much should be read into this generalization. In some situations, the issue probably was never raised; in some, the issue probably was not faced because unpersuasive testimony concerning the actor's thoughts was thoroughly discounted in view of obvious tax inducements; and in some, the distinction probably was regarded as too refined for the problem at hand. This is not to imply that the hypothetical average man has no place in classifying actions under the income tax; he often is somewhere on the scene, and his role will be considered later. All that is being noted here is that he rarely, if ever, is named as the standard for classification where a state of mind examination may be called for by the governing rule.

There is obviously a definite break in principle when we turn from state of mind rules to those that classify by the outcome of an action, and it is useful to compare these two types of rules. Admittedly, there may currently be no tax rules which specifically provide that classification of an action is to be postponed until the outcome of the action is known.³³ Under a few of our conclusory rules, however, a result can be

³³ See the tax treatment of preferred stock dividends, INT. REV. CODE OF 1954, § 306. Whether a later sale or redemption of the dividend shares gets ordinary income treatment or capital adjustment treatment depends on what the shareholder eventually does with all his shares in the particular corporation. However, it is not the treatment of the stock dividend distribution itself which is postponed; that distribution is, with exceptions, not taxed at all.

There are instances of a court adopting a "wait and see" tax rule and then backing

changed later if the taxpayer does something that is basically inconsistent with the earlier situation that first qualified him for a tax advantage.³⁴ We do have rules, moreover, under which a later event is classified on the basis of a look-back to earlier happenings.³⁵ Further, in many situations the strategies of controversy seem to leave us with echoes of wait-and-see type rules. Take the accountant who goes through law school. If he enters law practice after finishing school, we do not automatically disallow deduction of the tuition fees on the ground that in his case the outcome shows that the schooling is to be associated with becoming a lawyer. (Such a rule would require holding the ultimate issue in suspense for a year or more following the completion of the school program—a serious practical shortcoming and a potential source of confusion.) But the accountant's later course of conduct might nevertheless have a bearing on deductibility where that issue came up after the completion of his training. If he had in fact continued his accounting employment unchanged, there would be less likelihood that a claimed deduction would be resisted by the tax administrators. If, on the contrary, he had changed his vocation and had become a practicing lawyer, this fact would be seized upon as evidence that the schooling had not gone with bettering his capacities as an accountant. Such an argument might at first appear to be inappropriate if the accepted test concerned state of mind while in school. Experience tells us, however, that many times a later event is connected to earlier thoughts. We must therefore consider whether the probability of a connection is strong enough to warrant reading backward from the outcome to some earlier cogitation by the actor. In any case, it is reasonable that a heavy burden to demonstrate a favorable earlier state of mind should be put upon the taxpayer when his subsequent action is inconsistent with his assertions.³⁶

away from such an approach. An example is provided by the treatment of an agreement that both in form and in substance is a contingent lease-or-purchase arrangement. The court of appeals in *Kitchin v. Commissioner*, 340 F.2d 895 (4th Cir. 1965), originally decided to treat the arrangement as a straight purchase option and to wait for the eventual outcome of the transaction between the parties before deciding on its ultimate tax treatment. But on rehearing the court expressly recognized the difficulties inherent in that position and concluded that the transaction should be treated as a lease until such time as the option was exercised. *Kitchin v. Commissioner*, 353 F.2d 13 (4th Cir. 1965).

³⁴ See INT. REV. CODE OF 1954, § 302(c)(2)(a), dealing with a shareholder whose interest in a corporation is completely terminated by redemption of all his shares, but who thereafter acquires an interest in the corporation. The tax problem is whether the amount received in redemption is to be treated as a distribution of a dividend or as the equivalent of a sale of the shares to the company.

³⁵ The tax benefit rule is a good illustration. See INT. REV. CODE OF 1954, § 111.

³⁶ A much quoted version of the point is in *Army Times Sales Co.*, 35 T.C. 688, 704

These observations suggest a generalization about purpose and outcome. If the governing test classifies actions solely on the basis of outcome, the purpose of the actor is irrelevant. But that purpose is relevant if outcome is used only as an evidentiary circumstance from which to infer state of mind as of an earlier time.

In turning to classification of action based on comparative relatedness,³⁷ it is useful to begin by juxtaposing this method to classification based on a hypothetical average person's state of mind. An instructive problem is how these two tests can possibly differ in operation. Again, take the accountant case as an example. Suppose it is found that for an average person in the taxpayer's position, matriculation in law school would go along with becoming better equipped to function as an accountant, rather than with entering a new profession. Might it be consistent to find under a comparative relatedness test that attending law school is less closely tied to doing accounting work than to practicing law? The answer is yes, and the explanation is that the two tests in effect invite reflections on the affairs of two different populations. The hypothetical state of mind test calls for reflection on persons who attend law school under the configuration of circumstances that describe the case of the particular accountant. If it is found that the members of this "group" think that law training goes with improving their skill as accountants, then we will conclude that for them acquiring a law training is most closely related to practicing accounting. In contrast, the comparative relatedness test calls for reflection on all persons who go to law school. As to this "group," we could plausibly conclude that, on the whole, attending law school is not most closely related to serving

(1961): "The judicial ascertainment of someone's subjective intent or purpose motivating actions on his part is frequently difficult. One method by which such ascertainment may be made is to consider what the immediate, proximate, and reasonably to be anticipated consequences of such actions are and to reason that the person who takes such actions intends to accomplish their consequences. This reasoning is implicit in the Latin maxim '*acta exteriora indicant interiora secreta*' and in the more homely English adage 'Actions speak louder than words.'"

An illustration of the use of subsequent events in reaching a determination is provided in J. J. O'Donnell, 23 CCH Tax Ct. Mem. 210, 226 (1964), dealing with the application of INT. REV. CODE OF 1954, § 269, to deny a carryover of a corporation's net operating loss: "Subsequent events support the respondent's determination. After control of [the corporation] . . . was obtained by the partnership, the corporation liquidated its inventories and in a relatively short time ceased to carry on the manufacturing business it had theretofore conducted. It seems apparent that there was no intention of continuing to carry on [the corporation's] . . . business other than to liquidate existing inventory."

³⁷ The term "comparative relatedness" (or "comparative resemblance") is admittedly awkward, but it does serve as a shorthand expression for the type of test more fully described in the text.

When we speak of an action being "in the nature" of something, we usually are applying a comparative relatedness test.

as an accountant.³⁸ In reasoning in this latter way, however, do we really engage in anything other than a state of mind inquiry, considering that the same conclusion might very well rest on an inference about the state of mind of the average law school student? There is a difference, and in some situations it may be significant. The point is that to reach the conclusion on a comparative relatedness test, the inference about the average law student's state of mind is not necessary. The conclusion might rest at least as solidly on the observation that most law school graduates do practice law in one form or another—and this relationship between training and practice would stand regardless of what might be shown to have been their career thoughts during their years in law school.

These speculations suggest both how purpose can become associated with comparative relatedness and why such a usage can be misleading. On the basis of the general observation about the careers of law school graduates, one could say that the usual function served by attending law school is to train for the practice of law. One also could express this by saying that by and large in our society the purpose of attending a law school is to practice law. So worded, however, the proposition might be taken as being based upon state of mind considerations. It would be more direct and less confusing to say that, in general, matriculating in law school is most closely related to doing law work as a means of earning income.

It is worthwhile to illustrate a variation of this point with language in the Regulations defining what business income of an exempt organization is taxable because it is, in the terminology of the statute, "unrelated" to the functions that qualify the organization for exemption.³⁹ "Ordinarily, a trade or business is substantially related to the activities for which an organization is granted exemption," the Regulations say, "if the principal purpose of such trade or business is to further (other than through the production of income) the purpose for which the organization is granted exemption. In the usual case the nature and size of the trade or business must be compared with the nature and

³⁸ Note how a comparative relatedness test may be used to decide whether a certain activity is personal or business in nature: "[The principle] . . . may for practical purposes be said to constitute a distinction between those activities which, as a matter of common acceptance and universal experience, are 'ordinary' or usual as the direct accompaniment of business pursuits, on the one hand; and those which, though they may in some indirect and tenuous degree relate to the circumstances of a profitable occupation, are nevertheless personal in their nature, of a character applicable to human beings generally, and which exist on that plane regardless of the occupation, though not necessarily of the station in life, of the individuals concerned." Henry C. Smith, 40 B.T.A. 1038 (1939).

³⁹ INT. REV. CODE OF 1954, § 513.

extent of the activities for which the organization is granted exemption in order to determine whether the principal purpose of such trade or business is to further (other than through the production of income) the purpose for which the organization is granted exemption."⁴⁰ This is an unfortunate use of purpose. It is hardly likely that the Treasury means to interpret the statutory language—which obviously is concerned with a relationship between exempt function and business activity—as referring to the state of mind of the organization's officials in conducting the business. A more defensible interpretation would focus attention on what the business activity itself, again apart from the income it produces, in fact does or can contribute to furthering the function for which exemption is granted. That inquiry might perhaps be implemented by seeking to learn just what the organization's officials thought the activity did contribute. But the crucial judgment is not theirs; rather, it is ours—whether we think that the contribution is sufficiently direct or substantial to warrant classification of the activity as "related" to the exempt function. Such a determination is not advanced by locating anyone's purpose.⁴¹

The relationship between state of mind and external factors now may be seen in wider perspective. Judgments about a person's state of

⁴⁰ Treas. Reg. § 1.513-1(a)(4) (1958). After this article was set in type, the Treasury took steps to change the definition of an unrelated trade or business. In place of the test noted in the text, new Proposed Regulations call for substituting the following: "Trade or business is 'related' to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is 'substantially related' . . . only if the causal relationship is a substantial one. For the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes." 32 Fed. Reg. 5994 (1967).

⁴¹ To illustrate: Suppose that there are two identical agricultural colleges operating identical wheat farms in identical fashion. The fact that the officials of one school think that its farm is operated primarily to advance the education of its students, while the officials of the other think that its farm is operated primarily to produce income for the institution, should not cause the two operations to be treated differently for tax purposes.

Compare the problem of determining the primary purpose of an organization that operates a business and devotes all the income earned to furthering the functions which, standing alone, qualify the organization for the tax exemption under § 501(c). State of mind considerations seem to be wholly irrelevant here. While purpose in this context conceivably could refer to the use to which all income is finally put, the history of the governing statutory provision rules out this interpretation. Purpose could also refer to the size and extent of the business activities compared to the size and extent of activities in furtherance of exempt functions, taking into account the financial resources available for such functions. No other meaning of purpose in this context seems germane to the issue. See Eliasburg, *Charity and Commerce: Section 501(c)(3)—How Much Unrelated Business Activity?*, 21 TAX L. REV. 53 (1965).

mind can be made only by considering his own statements and by reflecting on external factors that seem to throw light on his thoughts.⁴² A state of mind test differs from a comparative relatedness test in that it allows us to entertain evidence on a broader spread of "facts" and leaves open the possibility of giving more credence to self-serving declarations. In most instances, we will reach the same result under the two types of tests, both because the evidence offered under the two tests will for the most part be the same, and because whenever the external factors point strongly in one direction we will likely be guided by them.⁴³ This means that it is in the "close" cases that the results reached under the two types of tests are most likely to diverge. When the external factors are viewed as persuasive, we may nevertheless speak of the actor's purpose—or motive or intent—but this often becomes mainly a convenient shorthand around which we group those factors that we regard as determinative. As we review repeating patterns of conduct, in some areas of taxation we tend to isolate and to label various external factors as indicative of state of mind.⁴⁴ Not infrequently we loosely speak as though these factors rather than state of mind were the ultimate test, thereby creating the impression that a comparative relatedness test is being invoked. And occasionally a particular external factor or combination of them is regarded as so persuasive that its presence or absence comes to be treated virtually as a conclusory rule.⁴⁵

⁴² The relative weights to be assigned to what a person says he had in mind in taking an action and what steps he in fact took are brought into focus by comparing several situations. If a person incurs expenses in preparation for doing something—such as taking a business trip—and the action is called off, we may have to rely heavily on his statements in determining how to classify the expenses. If he actually takes the trip, we can look to what he in fact did while away from his usual base of operations. Even where he cancels the trip, it sometimes may be possible to rely heavily on his actions rather than his statements; for example, he may have set up business appointments or committed business associates to attend.

⁴³ In a recent hobby case, the Tax Court said it could not find that the farm operation had ever been carried on in good faith for the purpose of making a profit; it noted that "the large losses sustained year after year speak for themselves." *H. V. Monette & Co.*, 45 T.C. 15, 47 (1966).

⁴⁴ Any state of mind test is likely to develop a set of subordinate rules of thumb which make explicit the external factors that are relevant in ascertaining state of mind. These make possible some consistency of treatment. See, as an example taken from the federal estate tax, *Estate of Johnson*, 10 T.C. 680 (1948), listing eleven relevant factors in determining whether a gift is or is not in contemplation of death, and pointing out that the list is not complete.

⁴⁵ For example, the general rule for determining whether a payment to a retiring employee is income or an excluded gift to the employee is the dominant state of mind test as expounded in the *Duberstein* case. See note 24 *supra*. Where, however, the employee involved is a clergyman receiving an honorarium upon retirement from his church, the transfer is usually treated as a gift without further inquiry. In theory, such cases

This whole matter may be put somewhat differently by saying that where under a state of mind test the external factors point strongly one way, we tend to ignore the actor's self-serving declarations about an incompatible state of mind because they are not credible.⁴⁶ We may arrive at the same place by saying that a reasonable or typical person would not have had the asserted state of mind and that the particular actor has not persuaded us otherwise. In the end, the vital question in applying a state of mind test may thus be how much allowance we are willing to make for an individual's quirks.⁴⁷

To round out the discussion, we should ask whether state of mind and comparative relatedness can be combined the other way around—that is, by assigning the former a role in determining the latter. An example seems to be furnished by a rule that the Tax Court once advanced for deciding what expenditures are to be classed as medical expenses under the statutory deduction for extraordinary medical expenses: “In determining allowability, many factors must be considered. Consideration should be accorded the motive or purpose of the taxpayer, but such a factor is not alone determinative. . . . [I]t is important to inquire into the origin of the expense. Was it incurred at the direction or suggestion of a physician; did the treatment bear directly on the physical condition in question; did the treatment bear such a direct or proximate therapeutic relation to the body condition as to justify a reasonable belief that the same would be efficacious; was the treatment in proximate time so near to the onset or recurrence of the disease as to make one the true occasion of the other, thus eliminating expense in-

turn on the thoughts of the donor; but the case law has developed what approaches a conclusory rule of law or an irrebuttable presumption. See Klein, *An Enigma in the Federal Income Tax: The Meaning of the Word “Gift,”* 48 MINN. L. REV. 215 (1963).

In determining when one who holds a house for personal use converts it into an asset held for the production of income or for profit, courts usually require certain overt acts to establish the change in the status of the asset. See *Rumsey v. Commissioner*, 82 F.2d 158 (2d Cir. 1936); *Schmidlapp v. Commissioner*, 96 F.2d 680 (2d Cir. 1938); cf. *Estate of Heine*, 10 CCH Tax Ct. Mem. 738 (1951).

⁴⁶ In *The Huddle, Inc.*, 20 CCH Tax Ct. Mem. 745, 749 (1961), a case involving the acquisition of a corporation having a loss carryover, the Tax Court said: “Although [the acquiring party] testified that his principal purpose in entering the transaction and buying [the acquired corporation's] stock was not to obtain a tax advantage, in our opinion, the surrounding circumstances and what was done with [the acquired corporation] immediately after the transaction was closed compel a different conclusion”

⁴⁷ In *Welsh v. United States*, 210 F. Supp. 597 (N.D. Ohio 1962), the court found that, despite numerous external facts pointing to the contrary, a revenue agent's primary purpose in taking a full course of study in law was to maintain or improve the skills required in his employment. The court noted that it had “had the opportunity to listen to the testimony of the taxpayer and observe his demeanor on the stand,” during which time his “credibility was called squarely into issue,” and that it had found “his testimony logical, consistent and true.” *Id.* at 599.

curred for general, as contrasted with some specific physical improvement."⁴⁸ Under this combination of standards, the role of state of mind is puzzling. The external factors apparently are not to be treated as evidence of the taxpayer's state of mind, and state of mind considerations apparently are not to be viewed as illuminating any of the external factors. Such a prescription is unrealistic. If the external factors suggest that an item is not a medical expense, why should we feel otherwise merely because the taxpayer thought he was spending money to treat an illness? And if the external factors suggest that an item is a medical expense, what chance is there that the taxpayer will reveal a contrary belief?⁴⁹

All this suggests that state of mind and external factors can be successfully combined only in one direction: the latter can be used to throw light on the former, but the process cannot be reversed.

III

Another persistent difficulty encountered in lining up state of mind and comparative relatedness tests is that any state of mind standard is likely to be very imprecise. To pinpoint this difficulty, we need to take a longer look at the problems of promulgating tests based on state of mind.

Any simple articulation of a state of mind standard is bound to hide a number of ambiguities. The case of the accountant in law school again supplies a useful illustration. Let us assume that classification in this area of education expenses is to rest on the taxpayer's state of mind; that is, the accountant's tuition in law school is to be deductible if his purpose in attending law school is to improve his skill as an accountant. And to sharpen the analysis, let us also postulate that by magic we have surmounted all the evidentiary barriers and have penetrated to the innermost thoughts of the taxpayer.

The first ambiguity is quickly detected. Up to this point, we have spoken loosely about whether in the accountant's thinking the law training is associated with improving his performance as an accountant,

⁴⁸ Edward A. Havey, 12 T.C. 409, 412 (1949).

⁴⁹ In the medical treatment area state of mind might be made to play a role where the expenditure not only alleviated an illness, but also benefited the taxpayer by training him for an occupation for which he was not formerly qualified. See David E. Starrett, 41 T.C. 877, 881 (1964), in which the majority said of a taxpayer who underwent psychoanalysis that qualified him for admission to a school of psychoanalytic training: "[W]hatsoever other reason petitioner had for undergoing psychoanalysis, he certainly had the intention, as soon as he could afford the treatment, to be thereby relieved of the physical and emotional suffering attendant upon the specific disease from which he had suffered throughout his adult life."

or with becoming a practicing lawyer, or with some other goal. But the reality, of course, is that we may expect him to have in mind more than one objective in attending law school. It therefore seems necessary to be more specific: Is deductibility to turn on whether the qualifying purpose—assumed here to be improving the taxpayer's abilities as an accountant—is found to be present to an important degree? Or is found to be a major purpose? Or is found to be the primary purpose? Or is found to be the only significant purpose?

The fact is that some of our statutory rules that apparently classify on a state of mind basis do not indicate what magnitude of the relevant qualifying purpose is sufficient. An illustration is supplied by the provision that limits deduction for losses or those incurred in transactions "entered into for profit."⁵⁰ In *Weir v. Commissioner*,⁵¹ the taxpayer bought dividend-paying stock in a corporation that owned a building in which he rented an apartment, and he did so "to have a choice in the management in order to 'maintain certain standards' "⁵² in the operation of the building. He sold the stock—at a loss—because he decided to move out of the apartment. The court of appeals, after observing that "we have a profit intention, side by side with a non-profit motive,"⁵³ put the question whether under these circumstances the taxpayer's intention to profit from the dividends satisfied the statutory requirement of a transaction "for profit." It concluded that the requirement was met, noting that the policy behind the loss allowance was that the government in effect said to taxpayers: "[I]f you intend to benefit us by producing taxable profits, you may take your loss . . . "⁵⁴ With this viewpoint accepted as a guide, the court decided that the profit aspect, which was taken "for granted,"⁵⁵ did not have to be primary and did not have to be balanced against the personal side of the transaction.

Other of our statutory tests that might seem to rest on state of mind are explicitly phrased in terms of "a major" purpose or "a principal" purpose.⁵⁶ Implementation of these tests calls forth the unexciting question of how much of the specified purpose is enough to satisfy the rule.

⁵⁰ INT. REV. CODE OF 1954, § 165(c)(2).

⁵¹ 109 F.2d 996 (3d Cir. 1940).

⁵² *Id.* at 997.

⁵³ *Id.* at 998.

⁵⁴ *Ibid.*

⁵⁵ *Ibid.* The court presumed that the taxpayer had had a profit motive for investing in shares likely to yield dividends, and it did not concern itself with whether he had ever thought about this prospect in making his investment. Such a probe would have been fruitless; if the taxpayer had been asked, he undoubtedly would have said he had considered the prospect of dividends from the shares.

⁵⁶ See note 6 *supra*.

Nothing very instructive can be said about such an obviously open-ended issue. Most of what appear to be our state of mind tests, however, are cast in terms of "*the primary*" purpose,⁵⁷ and it is with regard to this conception that numerous ambiguities have come to light.

An easily spotted one concerns the time interval that is relevant in determining primacy of purpose. In the case of the accountant attending law school, should the focus be on his purpose as of the day he applied for admission? Or the day he first attended class? Or every day he was enrolled in school? Further, should the deductibility of tuition under the test change with every important change of mind by the taxpayer as to his reasons for being in school? A strict formulation of a primary purpose test might demand answers to these and similar questions. While answers can readily be produced, we often avoid giving them.⁵⁸ Instead, we seem generally to assume that the taxpayer's thoughts during the whole or most of the action should somehow be taken into account. Even when we are asked to be more specific, our responses frequently are vague. The fact is that under some rules it is far too awkward or confining to be precise in designating the crucial time span, mainly because, in a sense, the action that is to be classified is not a single undertaking but a series of events accompanied by thoughts that differ one from another. Under such circumstances we sometimes find it more comfortable to say what time period is not appropriate or controlling or to indicate the relative importance of the various points of time covered by the events that we are required to treat as a single action.⁵⁹

Another ambiguity concerns the meaning of "purpose" when we are searching for a person's primary purpose. Suppose that before entering and while in law school the accountant conducted an exhaustive dialogue with himself on why he was interested in studying law. He entertained a number of ideas at one time or another: he figured that law training might enhance his career as an accountant; he speculated that he might go into law practice if a good opportunity presented itself; he had a notion that a law degree might give him status in the eyes of

⁵⁷ See note 6 *supra*.

⁵⁸ In *Owen L. Lamb*, 46 T.C. 539, 543 (1966), the Tax Court said that "it seems to us that the proper time to look for the primary purpose of a taxpayer in obtaining education is the time that the taxpayer first firmly decides to undertake that education." But the time problem was easy, for there was "no evidence in the record to indicate that the petitioner's primary purpose changed at any time throughout his 4-year course of training and education." *Id.* at 544.

⁵⁹ Consider, for example, the case of a dealer in real estate who seeks capital gain treatment on the ground that certain property sold through his regular sales organization was held for investment and not for sale to customers in the ordinary course of business. In such a case we readily say that an investment objective at the time of acquiring the asset is relevant but not of great weight, while we draw back from saying that the tax-

the community and his wife; and he reflected on the possibility that studying law would be an enjoyable way of utilizing his spare time. In such a setting, does mere awareness of the possible advantages of attending school become a purpose? Or does purpose refer to the satisfactions associated with awareness of the various advantages? Or does it imply some personal resolve or commitment to achieve the contemplated satisfactions? Again our law does not seem to have found it necessary to address these questions explicitly. Somehow, we have been able to operate by equating purpose with an end in view, meaning anything that is regarded as having had an effect upon producing the decision to undertake the action being scrutinized.⁶⁰ Any other position would likely be too precarious—especially in view of how little we comprehend about mental processes.

A further ambiguity deals with the requirement of finding a “primary” purpose. Assume that we are able to isolate the accountant’s various goals for attending school and that we agree that these constituted his purposes. Does the search for finding “primacy” among them call for measurements that presuppose the existence of a common denominator? Here it might be noted that even if we think we can meaningfully weigh various income-producing objectives for attending school, we should be less sanguine about devising methods for comparing business and personal objectives. If the accountant thought about the pleasures of law school more often or for longer periods than he thought about its career aspects, would we necessarily conclude that his personal ends outweighed his professional objectives? Or if his thoughts about

payer’s purpose in holding the asset immediately before the sale is crucial. Underlying this evasiveness may well be a recognition that the substantive law is framing an issue which is inherently difficult to manage. The mere fact that the dealer sold the asset through his sales organization suggests that for at least the moment prior to the sale the asset was being held for sale to the purchaser in the ordinary course of the dealer’s business. Yet this cannot be conclusive, since it would deny capital gain treatment to all property sold by dealers through their own organizations—even assets that they clearly had held as investments. We must therefore go back further than the time of sale.

An illustration of how courts have responded to the time issue is furnished by the instruction given to the Tax Court by the court of appeals in a case involving various parcels of realty sold by a corporation whose sole business activity over a number of years had apparently been buying, holding, renting, and selling real estate: The Tax Court “should not limit its consideration solely to circumstances existing at the time of sale but should also consider the purpose for which the property was acquired, the purpose for which it was held, the motive at the time of sale, and the method of sale.” *Municipal Bond Corp. v. Commissioner*, 341 F.2d 683 (8th Cir. 1966).

⁶⁰ Speaking of the meaning of the phrase “major purpose” in § 1551 of the Code, the Tax Court has said that “the major quality of a ‘purpose’ within the framework of the statutory sections here involved is to be determined in the light of the effect which consideration of securing the exemption and credit had upon producing the decision to create or activate the new corporation.” *Truck Terminals, Inc.*, 33 T.C. 876, 885 (1960).

future business possibilities were less intense than his thoughts pertaining to personal pleasure, would we be certain of the conclusion to be drawn? We might be able to decide that the business aspects were of small or of great significance, and we might also be able to reach such a conclusion about the personal pleasure aspects. But is there any theoretical basis for weighing these on the same scale? Wisely, or perhaps out of necessity, tax law has wholly ignored this challenge, thereby further increasing the vagueness surrounding any primary purpose test.

Another ambiguity concerns a different facet of defining "primacy" in searching for primary purpose. Assume that all the other ambiguities have been resolved—that we are able to delineate, evaluate, and compare the significance of all the accountant's various purposes in attending law school. Then suppose that our mind-reading score card indicates that he went through law school because he wanted to improve his performance as an accountant (weight = 40 per cent), because he planned to enter the practice of law if a good opportunity turned up (weight = 40 per cent), and because he expected to enjoy the schooling (weight = 20 per cent). It is clear that improving accounting skills is "primary" in the sense that no other single purpose is more significant. But it is not "primary" in the sense that it outweighs all the other purposes together. It may or may not be "primary" in the sense that it alone was sufficient to induce the taxpayer to study law. Further, it may or may not be "primary" in the sense that but for it the taxpayer would have eschewed the study of law. Any precise statement of a primary purpose test would obviously need to fix on one of these meanings.

The difficulty in being so precise is illustrated by the recent opinion of the United States Supreme Court in *Malat v. Riddell*.⁶¹ According to the statutory rules, profit on the sale of real property is ordinary income if the asset was "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business,"⁶² while the profit on sale of real property "used in" the taxpayer's trade or business qualifies for capital gain treatment.⁶³ It is not uncommon to find real estate dealers holding certain properties either to rent or to sell, depending on what opportunities develop. In *Malat*, the District Court denied capital gain treatment upon finding that the properties had been held for the dual purposes of rental or sale, and that sale had been an essential purpose.⁶⁴ The court of appeals affirmed, using language suggesting that

⁶¹ 383 U.S. 569 (1966).

⁶² INT. REV. CODE OF 1954, § 1221(1).

⁶³ INT. REV. CODE OF 1954, § 1231.

⁶⁴ 64-1 U.S. Tax Cas. ¶ 9432 (S.D. Cal. 1964).

under some circumstances capital gain treatment is appropriately denied if both the rental and the sale purposes in holding the asset were substantial.⁶⁵ The Supreme Court reversed, stating that "primary" means "principal" and not "substantial."

This clarification could be read as being trivial in scope. If the Court's language were taken literally, the result under the "held principally for sale" standard would differ from that under the "held substantially for sale" standard only in the most unlikely case of an asset held equally for rent or sale. But such a trivializing view of the Court's opinion seems unwarranted, especially since another interpretation is plausible. Suppose it is found that a taxpayer's sole business over a number of years was buying, holding, renting, and selling real estate, and that he held a certain building "with the principal objective of realizing the best profit available therefrom, whether it be from rental or sale, whichever seemed best at the time."⁶⁶ A literal application of the Supreme Court's interpretation of the primary purpose test would deny capital gain treatment to profit on sale of the particular building in this situation because the sale purpose did not outweigh the rental purpose. But, as urged in a recent Tax Court opinion, one could say that both the sale purpose and the rental purpose were primary in the sense that both were of the "first importance," as contrasted to being of "substantial" importance.⁶⁷ Such a reading of the proposition that "primary" means "principal" and not "substantial" would give the Court's opinion applicability beyond the rare case in which two purposes are exactly equal; moreover, it would harmonize with our awareness that precise definition and measurement of complementary purposes are out of reach.

To all these obstacles of articulating and applying a primary purpose test, a perceptive contemporary commentator would add another: "The problem is that the test in many situations simply has no reference or relation to reality; it presumes the existence of mental phenomenon that in fact may not occur."⁶⁸ The accountant who went to law school, for example, may never have thought his way through the question of why he enrolled. In deciding to go to law school, there is no reason for him to decide what his purposes are. Doubtless, there are numerous situations in which the actor has had no occasion to put to himself the question which the tax law raises under the "primary purpose" stan-

⁶⁵ 347 F.2d 23 (9th Cir. 1965).

⁶⁶ *Municipal Bond Corp.*, 46 T.C. 219, 229 (1966). These facts are taken from *Municipal Bond Corp.*, 41 T.C. 20 (1963).

⁶⁷ *Municipal Bond Corp.*, 46 T.C. 219, 229 (1966).

⁶⁸ Klein, *Deductibility of Transportation Expenses of a Combination Business and Pleasure Trip—A Conceptual Analysis*, 18 STAN. L. REV. 1099, 1110 (1966).

dard. The test thus often asks us to reach a conclusion based on mental processes that probably never took place.

While this observation is cogent, we should pause long before invoking it to find serious fault with a primacy of purpose test. Much of our law presumes that persons complete various mental processes, although they very likely never go the distance. The law's outlook on primary purpose is in line with its general postulates that man both is rational and possesses free will. These are notoriously vast exaggerations. Nevertheless, over the years we probably have not been too far off base in pretending that we can reconstruct the thoughts of people by employing these postulated characterizations of human nature. A primary purpose test is hardly more unrealistic or more demanding than many another familiar construct of the law.

Putting together all these reflections on a primary purpose test, one conclusion is bound to emerge. The test cannot be made very precise, and it is workable only so long as a great deal of vagueness is accepted. In cases that are at all "close," the test can call only for an overall impressionistic judgment—a judgment in which all ambiguities regarding the meaning of purpose, the evaluation of differing purposes, and the definition of primary are almost wholly submerged or finessed. A determination of primary purpose in such cases necessarily resembles a jury's general verdict, and it frequently is no more susceptible to detailed, structured analysis.

Earlier it was noted that where external factors are given great weight, there is likely to be difficulty in distinguishing a state of mind test from a comparative relatedness test. What should now be added is that this difficulty is greater when classification is put at the level of overall impressions. It will be recalled that in operation any state of mind test tends to rest heavily on introspection. As the test is allowed to become less precise and more impressionistic, we are in many instances less likely to concentrate on the thoughts of the particular taxpayer and more likely to speculate about the total setting.⁶⁹ The result is to move the state of mind test even closer to a comparative relatedness test.

This loss of distinctiveness seems to be illustrated by the history of a change in the Regulations covering the deductibility of travel fares.

⁶⁹ In analyzing whether old motion picture films, used by their producers in their businesses of renting films for exhibition, might also be held for sale to television outlets, the Internal Revenue Service noted that the motion picture industry recognizes "the distinct possibility that its films might be sold for exhibition on television after being leased for theater showings," and that producers generally contemplate "sales to television following such showings as a likely means of exploiting their product." Rev. Rul. 62-141, 1962-2 CUM. BULL. 182-83, 185.

For many years the Regulations used language that was construed as meaning that a primary purpose test governed the treatment of combination business and pleasure trips. Then the Regulations now in force were adopted, containing the provision that travel fares in such combination trips are deductible "only if that trip is related primarily to the taxpayer's trade or business."⁷⁰ It has been said that a significant change in principle was apparently introduced—a shift from a state of mind test to a comparative relatedness one. Yet the change has hardly been noticed, and there is no evidence of any effect upon the results reached. The explanation may well be that in practice the two tests become virtually alike.

IV

Much of the literature on motive, intent, and purpose in taxation concerns so-called tax avoidance. We turn now to consider the role assigned to state of mind in deciding what actions or transactions are to be condemned as constituting tax avoidance.

Let us start with the accumulated earnings tax that is imposed on any corporation "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders . . . by permitting earnings and profits to accumulate instead of being divided or distributed."⁷¹ The statute refers to "the purpose"; although the point is not free from doubt, this is usually taken as meaning the principal purpose. A key provision in the statute states that "the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary."⁷² Thus, at the heart of the statutory arrangement are two conceptions: (1) the overriding one of proscribed "purpose"—which in principle seems to refer to state of mind; and (2) the subordinate one of reasonable business needs—which in principle seems to refer to external factors.⁷³ The two ingredients apparently are to retain independent vitality.⁷⁴ If, for

⁷⁰ Treas. Reg. § 1.162-2(b)(1) (1958).

⁷¹ INT. REV. CODE OF 1954, §§ 531, 532(a).

⁷² INT. REV. CODE OF 1954, § 533(a).

⁷³ "What is here overlooked is that 'the reasonable needs of the business' test . . . is itself a psychological test. . . . [T]he 'needs of a business' means very little except in reference to a *mental conception* of what the business should be or what it requires." Ballantine, *Psychological Bases for Tax Liability*, 27 HARV. BUS. REV. 200, 204 (1949).

⁷⁴ The discussion in the text omits consideration of § 535(c)(1), added in 1958 to the Internal Revenue Code of 1954, under which the penalty tax is never imposed to the extent that earnings and profits are retained for the reasonable needs of the business. "Even if the taxpayer was motivated by the interdicted purpose, then, no tax would be

example, it is demonstrated that the accumulation exceeded the reasonable needs of the business, the corporation is nevertheless to be given the opportunity to rebut the presumption that the proscribed purpose was present. A review of the litigation, however, reveals that where the reasonable needs issue goes against the taxpayer, there is only an outside chance of establishing directly a dominant purpose other than the proscribed one.⁷⁵ This asymmetrical relationship between purpose and external factors is more fully understood when the situation is turned around and it is assumed or demonstrated that the accumulation could be justified by the business needs. Prior to a recent statutory change, the government in theory prevailed here if the tax administrators determined that the accumulation was principally activated by the proscribed purpose, and if the corporation failed to overcome the presumption of correctness that favors the administrative determination. But how can the taxpayer ever disprove the existence of the proscribed purpose?⁷⁶ The most promising avenue lies not in trying to show an acceptable set of thoughts attributable to the corporation, but rather in demonstrating that the accumulation was associated with reasonable needs of the business. The whole point was succinctly put by the court of appeals in *Young Motor Co. v. Commissioner*: "While the ultimate question here is not the reasonable needs of the business, the answer to that question may well be the single most important consideration in

imposed if the accumulation were found to be reasonable. The implication is that Congress may not really care about the subjective intent of the taxpayer at all." Note, *Accumulated Earnings Tax: Burdens of Proof of Reasonableness and Purpose*, 54 CALIF. L. REV. 1050, 1060-61 (1966).

⁷⁵ Sometimes the taxpayer does succeed. In *Heyward & Co. v. United States*, CCH 1966 STAND. FED. TAX REP. (66-2 U.S. Tax Cas.) ¶ 9667, at 87, 187-88 (W.D.N.C. Sept. 1, 1966), the court found that the "taxpayer's accumulations of income were far in excess of the reasonable needs of its business," but that the dominant stockholder's "sole purpose in having the [corporation] . . . retain its earnings instead of paying them out in dividends was to build a so-called 'reserve' for the protection of the [corporation's] . . . business, and he was not motivated at all by a tax avoidance purpose." The judge commented: "The taxpayer's accumulations of income were fantastic. I do not believe that one bent upon tax evasion would have the unmitigated gall to attempt it in such an obvious manner." *Id.* at 87, 183-84.

The trend, however, is moving in the opposite direction. "Recent judicial decisions have tended to further reduce the importance of the subjective test . . . In [two cases] the Tax Court concluded, on the basis of an exhaustive study, that all, or a portion, of the respective corporation's earnings were accumulated beyond the reasonable needs of the business, and then, without a further sentence of explanation, determined that to the extent of such unreasonable accumulation the prohibited purpose was present." Ziegler, *The "New" Accumulated Earnings Tax: A Survey of Recent Developments*, 22 TAX. L. REV. 77, 79 (1966). The author concludes that the subjective test has been reduced in importance to a "last hope" argument for the taxpayer. *Id.* at 81.

⁷⁶ Of course, the reasons why a corporation does something can only be the reasons why those guiding the corporation cause it to act as it does.

concluding whether the taxpayer acted with a proper purpose in mind, or the proscribed one."⁷⁷ The upshot is that, despite a statutory test framed in terms of purpose, state of mind turns out to have surprisingly little significance.⁷⁸

These reflections on state of mind and business needs set the stage for viewing parallel relationships, but of much broader reach. In a number of areas the statutory rules explicitly prescribe that certain actions involving the use of business entities are to be accorded advantageous tax treatment provided that the actions are not tainted by tax avoidance. For example, where a corporation is divided among its owners into two or more corporations, the tax result under specified conditions is to depend on whether the action was "in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax."⁷⁹ And although our law has never developed an all-embracing principle that every action must pass an anti-tax avoidance threshold before qualifying for favorable tax treatment, traces of such a notion have been read into numerous statutory provisions.⁸⁰ On quick impression, all variations of the anti-tax avoidance principle may appear to rest on a state of mind foundation; for they seem to announce that if a taxpayer does something with the thought of avoiding taxes, he will not be permitted to enjoy the tax advantage he sought.

A moment's reflection will show why such an interpretation of the anti-tax avoidance principle is untenable. In our society all taxpayers can be expected to arrange their affairs so as to minimize taxes, and in general we do not condemn actions that save taxes. If tax-reducing actions are to pass muster but tax avoidance actions are to be penalized, some way of distinguishing between the two must be located. The trouble is that, as a mental phenomenon, a desire to minimize taxes does not differ from a desire to avoid taxes. It clearly would be foolish to attempt to define tax avoidance as merely a more intense or pervasive version of tax minimization. Conceivably, one might try to separate the tax reduction thoughts from all the non-tax thoughts associated with

⁷⁷ 281 F.2d 488, 490-91 (1st Cir. 1960).

⁷⁸ As a historical curiosity, it might be noted that, when the constitutionality of the tax on improper retention of earnings was challenged, the Supreme Court took the questionable view that the tax was not based on state of mind because "the existence of the defined purpose is a condition precedent to the imposition of the tax liability" upon the retained earnings. *Helvering v. National Grocery Co.*, 304 U.S. 282, 289 (1938).

⁷⁹ INT. REV. CODE OF 1954, § 355(a)(1)(D)(ii).

⁸⁰ Some commentators have urged that it is "much more difficult . . . to enforce liability dependent on such illusive criteria [as motive] when the part to be played by such criteria is nowhere specified in the statute." Sutherland, *Taxpayers' Motive as a Basis for Taxability*, N.Y.U. 8TH INST. ON FED. TAX 990, 991 (1950). The analysis in the text suggests that the proposition is of doubtful validity.

an action, and then treat a comparatively large quantity of the former as tax avoidance. But such an approach, aside from being wholly impractical, would lack justification. It would penalize taxpayers who sought professional counsel or were familiar with the tax laws, while rewarding those who were uninformed about the tax system or placed a low value on conserving dollars.

The usual course around these difficulties has been to compare the importance of the actor's tax reduction objective—sometimes required by statute to be presumed—and of his non-tax objectives, if he has any. Tax avoidance is then, in effect, defined as an action taken under circumstances where the non-tax goals are of insufficient weight as balanced against the tax reduction goal.⁸¹ Under this approach, the taxpayer has the burden of showing the existence and significance of any non-tax objective.⁸² Usually, the most convincing proof is a demonstra-

⁸¹ No general statement can be made about the "weight" an acceptable purpose must have in order to tip the scales. This matter is dealt with differently in various areas of tax law.

Some of the anti-tax avoidance provisions leave us with a difficult problem of defining the proscribed action. Consider, for example, INT. REV. CODE OF 1954, § 341, dealing with so-called collapsible corporations. The section penalizes shareholder gains which are associated with a collapsible corporation. Collapsibility is presumed if certain external facts are present and if the absence of collapsibility is not shown. The central notion in the definition is that a corporation is collapsible if it is "formed or availed of principally for the manufacture, construction, or production of property . . . with a view to—(A) the sale or exchange of stock by its shareholders . . . or a distribution to its shareholders before the realization by the corporation . . . of a substantial part of the taxable income to be derived from such property, and (B) the realization by such shareholders of gain attributable to such property." INT. REV. CODE OF 1954, § 341(b). The phrase "with a view to" has been defined to mean "intending" or "calculating upon or contemplating as a desired result." The statute does not indicate what degree of "intending" calls into play the penalty provisions. The Treasury Regulations interpret the statute to mean that the intent requirement is satisfied if the collapsible transaction was "contemplated by those persons in a position to determine the policies of the corporation" and if the transaction was merely contemplated by them "unconditionally, conditionally, or as a recognized possibility." Treas. Reg. § 1.341-2(a)(2) (1955). This seems to indicate that it is sufficient for the controlling persons to have recognized or known that the possibility of collapse existed and that there would be a gain to shareholders. A commentator has complained that the statutory use of the term "view" requires "a subjective inquiry, and this is something more than a conscious regard of the possibility of collapse. It is felt that . . . the requisite view must be one which is contemplated as a substantial reality, although such need not be the dominant reason. 'Substantial reality' means a strong or true state of facts. When applied to intent it means something less than a dominant intent" Pelletier, *Shareholder Intent and Congressional Purpose in the Collapsible Corporation* Morass, 20 TAX L. REV. 699, 710-11 (1965).

⁸² Where a corporation is involved, there is a question whether acceptable non-tax objectives include objectives that serve only the personal or non-corporate business interests of the shareholders, as opposed to objectives that advance the interests of the corporation. See *Parshelsky's Estate v. Commissioner*, 303 F.2d 14 (2d Cir. 1962), which took the latter view; cf. Treas. Reg. § 1.355-2(c) (1955). There is a high degree of artificiality in conceiving of the corporation as having objectives wholly apart from those of its shareholders.

tion that the action in question did serve or plausibly could have served a significant non-tax goal.⁸³ If the taxpayer succeeds in showing an important non-tax goal, we are drawn to conclude that the tax reduction objective was comparatively not so great that the action amounted to tax avoidance. If the taxpayer cannot make such a showing, we are drawn to the opposite conclusion.⁸⁴

The balancing point is not a constant for all tax rules that incorporate an anti-tax avoidance principle. Because these various substantive rules have vastly differing potentials for tax minimization and because in our tax structure they serve functions of differing significance, certain of them may be viewed as calling for weightier non-tax goals than do others. Such differentials are not to be found on the face of the rules, but rather they develop in the process of our applying the rules and observing the consequences.

In some types of situations, we regard the plausibility of a particular non-tax objective as so low that we eventually fashion a general rule that precludes ever giving any weight to that objective. This development may be illustrated by the history of the litigation relating to the plan of purchasing a deferred annuity contract and then "borrowing" against the cash value of the policy simultaneously with the payment of each premium. The tax reduction objective of the plan was clear. The taxpayer hoped first to deduct the "interest" he paid on the "borrowed" cash value, and later to realize the increased cash value of the policy (attributable to interest earned on the premiums) in the form of a capital gain rather than ordinary income. On its surface, the arrangement had the effect of giving the taxpayer an option, enforceable at a future date, to annuitize a sum of money at the interest rate and mortality assumption reflected in the annuity contract. When the Supreme Court

⁸³ Proposed regulations would deny taxpayers relief from an unfavorable reallocation of charges among related business entities under § 482 of the Code unless the circumstances giving rise to the reallocation "did not have as one of their principal purposes the avoidance of Federal income tax." It has been strongly contended that "the 'tax avoidance' concept appears to contribute little to a rational resolution of the question at issue," and that a more appropriate standard would be whether "the arrangements or transactions . . . reflected an effort in good faith to comply with the tests set forth in the final regulations under Section 482 or otherwise to arrive at changes comparable to those which would have resulted from arm's length bargaining between unrelated parties." Miller, *Proposals for Amelioration of Section 482 Allocations Affecting U. S. Taxpayers with Foreign Affiliates*, 44 TAXES 209, 254-55 (1966) (emphasis deleted).

⁸⁴ In most cases won by the government under a business purpose test, the actor is unable to establish that he had any business purpose that was more than trivial or made up out of whole cloth. There are cases, however, in which the courts talk as though they believe that there were mixed motives—tax reduction and business objectives—and that the former was predominant. See, e.g., *J. T. Slocumb v. Commissioner*, 334 F.2d 269 (2d Cir. 1964). In some of these mixed motive cases it seems likely that, if pressed, the courts would find the asserted objectives to be fictitious or insubstantial.

considered the arrangement in *Knetsch v. United States*,⁸⁵ the majority, in essence, held that there was no borrowing but only a payment to obtain a tax advantage—and that without a loan there could be no interest element to deduct. In arriving at its result, the Court must have concluded that the asserted non-tax goal of acquiring annuity rights (or of creating, through borrowing the cash value, what might have been characterized as creating an option to annuitize a sum in the future on guaranteed terms) was not sufficiently plausible to merit consideration.⁸⁶ Once this step had been taken, other participants in similar annuity borrowing plans who litigated their rights to interest deductions lost hands down.⁸⁷

In determining whether the anti-tax avoidance threshold has been satisfied, not every type of non-tax objective is necessarily to be taken into account. In the area of corporate adjustments, for example, the statutory rules provide that the only non-tax goals that count are those that can qualify as “business purposes.”⁸⁸ But in the case of some other statutory provisions, the courts have indicated that all non-tax purposes are to be considered. In the recent case of *Goldstein v. Commissioner*,⁸⁹ for example, the taxpayer borrowed at interest to buy government

⁸⁵ 364 U.S. 361 (1960).

⁸⁶ See Blum, *Knetsch v. United States: A Pronouncement on Tax Avoidance*, 1961 SUP. CT. REV. 135.

⁸⁷ One commentator put the *Knetsch* case in these terms: “Although some writers have rationalized the decision on lack of economic significance, it is not economic significance which was absent from the transaction (which had significant results in payment of spendable dollars by the taxpayer and realization of taxable income by the payee) but an economic purpose other than tax saving. Putting the question in terms of net effect would result in the same answer. Here, as in the *Gregory* case, inquiry into the objective economic purpose of the taxpayer can avoid delving into his subjective motive only because the question is so clear on its facts that the transaction could not have had an economic purpose, or motivation, apart from tax avoidance. The possibility of a business purpose is absent. . . . However, as in the business purpose cases, the rationale of *Knetsch* becomes unpredictable in its application to situations involving possibilities of economic gain as well as tax advantage.” Fuller, *Business Purpose, Sham Transactions and the Relation of Private Law to the Law of Taxation*, 37 TUL. L. REV. 355, 370-71 (1963).

⁸⁸ A particular business purpose which is regarded as sufficient under one statutory rule may not be considered sufficient under another. See Jacobs, *The Anatomy of a Spin-Off*, 1967 DUKE L.J. 1, 30-35.

Courts do not always apply a business purpose test to corporate transactions that have a high potential for tax reduction. In *Sun Properties, Inc. v. United States*, 220 F.2d 171 (5th Cir. 1955), the court refused to apply such a test to a transfer in the form of a sale to a wholly-owned corporation, saying that “we would be most reluctant to impose a court-made requirement of a business purpose independent from taking a gain or loss, in determining the genuineness of sales in general, since it is common knowledge that vast numbers of sales have been made and are still being made for the purpose of taking gains and losses at times which provide the optimum tax benefits.” *Id.* at 175.

⁸⁹ 364 F.2d 734 (2d Cir. 1966).

obligations yielding a lesser rate of interest in order to shift taxable income from one year to the next. After noting that "there is no requirement that deductible interest serve a business purpose, that it be ordinary and necessary, or even that it be reasonable," the court of appeals took the position that the deduction for interest payments is available where, in borrowing money, the taxpayer desires "to engage in purposive activity."⁹⁰ According to the court, "the interest deduction should be permitted whenever it can be said that the taxpayer's desire to secure an interest deduction is only one of mixed motives that prompts the taxpayer to borrow funds; . . . the deduction is proper if there is some substance to the loan arrangement beyond the taxpayer's desire to secure the deduction."⁹¹ Apparently any non-tax goal would satisfy this criterion.

The purposeful activity approach may conflict with another principle of our tax system. In some situations, as noted later, we may wish to permit the form of a transaction to govern its tax consequences without an inquiry into whether non-tax goals are served by use of the particular form. It might appear that the two policies could be reconciled by holding that where form is to govern, it is to do so only if the action itself is purposeful. Accepting such a doctrine, however, would amount to abandoning the notion that in certain situations form alone is to control, regardless of any other considerations.

Further light on the role of state of mind in the anti-tax avoidance area is shed by looking at the situation where it is agreed that the parties did not harbor tax minimization thoughts. What should be the result, for example, where it is found that a corporate adjustment "had no business reason and . . . had no tax avoidance purpose," but that the change put the shareholders in such a position that they "have and will continue to have a tax advantage whenever they chose to make use of it, even though . . . they never thought of the reorganization in terms of a tax advantage"?⁹² The court of appeals in the recent case of *Commissioner v. Wilson* candidly stated that "in this practical area of taxation, so much in the way of liability for taxes can hardly be allowed to depend solely upon what goes on in someone's mind."⁹³ It then went

⁹⁰ *Id.* at 741.

⁹¹ *Ibid.*

⁹² *Commissioner v. Wilson*, 353 F.2d 184 (1965).

⁹³ *Ibid.* The Code section governing corporate divisions—the type of adjustment involved in the *Wilson* case—states that to come within the section's advantageous provisions, a transaction must not be used principally as a device for the distribution of the earnings and profits of either of the resulting corporations. INT. REV. CODE OF 1954, § 355(a)(1)(B). It has been said: "This is a statutory underlining that the business purpose, anti-tax avoidance doctrines are here specially relevant—a statement that Congress is

on to say that the mere absence of thought about tax consequences should not be enough to qualify a corporate adjustment for advantageous treatment: "Congress . . . was trying to give business leeway in readjusting their corporate arrangements to better suit their business purposes. If the rearrangement had that purpose, Congress was willing to concede them some possible tax advantages. If the rearrangement had no business purpose, let the taxes fall where they might."⁹⁴ Under this view, it is the presence of an acceptable purpose rather than the absence of tax reduction thinking that is the decisive concern.⁹⁵

It is instructive to note several troublesome questions that might be relevant to deciding whether in a particular case an acceptable and sufficiently important non-tax reason exists for an action that clearly does reduce taxes.⁹⁶ As an illustration, let us consider application of the

aware the area is one of high tax avoidance potential and is demanding that administrators and courts approach it with the necessary alertness and sophistication." SURREY & WARREN, *FEDERAL INCOME TAXATION* 1640 (1960 ed.).

⁹⁴ Commissioner v. Wilson, 66-1 U.S. Tax Cas. ¶ 9103, at 85,014 (9th Cir. 1965).

⁹⁵ Predicating tax consequences on a finding of business purpose has been attacked as unsatisfactory: "In the first place it requires the ascertainment of the ultimate purpose of those in charge of the business, a task which at best is extremely difficult. In the second place it places business men under a cloud of uncertainty and prevents them from foreseeing with any accuracy the effect of their present transactions. Thirdly it opens the door for the substitution of the business judgment of the tax officials, who often have none, for that of the taxpayers involved." Sutherland, *Taxpayers' Motive as a Basis for Taxability*, N.Y.U. 8TH INST. ON FED. TAX 990 (1950).

Use of a business purpose doctrine in deciding whether to recognize devices designed to split income among members of a family has been criticized as improper: "The reasoning of the courts, however, has rarely included a consideration of whether Congress intended the tax benefits to be extended to the transaction in question. Generally, as soon as the court finds that no valid business purpose exists the tax benefits are automatically disallowed. There is virtually no recognition of the fact that the mere failure to serve business or [other] . . . non-tax purposes does not necessarily indicate that the device is entitled to no tax recognition. For example, even though the gift and lease back device generally does not perform a non-tax function [other than altering the allocation of taxable income] . . . does not indicate that the device is unworthy of tax recognition." Note, *Income Splitting as a Means of Avoiding Taxes*, 19 VAND. L. REV. 1289, 1327-28 (1966). See Alden B. Oakes, 44 T.C. 524, 532 (1965).

⁹⁶ In places the statutory language is not clear whether the test for classifying a transaction calls for weighing business purpose against tax reduction possibilities or for looking only to the net effect of the transaction. An example is the provision that a distribution in redemption of shares is not a dividend if it "is not essentially equivalent to a dividend." INT. REV. CODE OF 1954, § 302(b)(1). In Commissioner v. Sullivan, 210 F.2d 607 (5th Cir. 1954), where the distribution was pro-rata among the shareholders, a dissent argued that this fact plus the presence of a large undistributed surplus were sufficient to make a dividend classification appropriate, and that business purpose and the intent of the taxpayer were immaterial in determining the effect of the transaction. The majority, however, took the position that whether a distribution is essentially equivalent to a dividend is a question of fact to be decided after considering all circumstances, including business purpose and the intent of the shareholders. See note 29 *supra*.

statutory provision denying certain normally available tax benefits where a person acquires a corporation or corporate property for the principal purpose of obtaining those tax benefits.⁹⁷ Assume that all the stock of a corporation having a large operating loss carry-forward is acquired by an individual proprietor, who then transfers his established business into the corporation. Assume also that the acquired corporation has a combination of assets which are readily usable in the proprietor's business, and that the proprietor asserts he bought the shares in order to get control of these assets.⁹⁸ How should we go about deciding whether deduction of the loss carry-forward against income generated after purchase of the shares is to be denied on the ground that the principal purpose of the acquisition was to obtain the benefit of the carry-over?

A first question is whether we ought to regard getting control of the corporation's assets as a significant purpose if it can be shown that the acquirer could have obtained them by another route, albeit one that would not have afforded him the opportunity to benefit from the loss carry-forward. Are we, in short, to infer the absence of a particular asserted purpose from the presence of a reasonable commercial alternative? To take such a road would come close to indulging in the absurd proposition that people should act so as to maximize their taxes. It seems more fitting to ask whether the acquirer would have gone through with the transaction as structured even in the absence of any tax advantage, and then to say that an affirmative answer indicates that he had a non-tax purpose in view.⁹⁹

A second question deals with the weighing of objectives. In determining whether a non-tax objective was or was not the principal purpose, should account be taken of the dollar significance of both that objective and the tax advantage that was sought?¹⁰⁰ The difficulty here is

⁹⁷ INT. REV. CODE OF 1954, § 269.

⁹⁸ If there is a discrepancy between the design the acquirer professes to have had in mind and his later conduct, a heavy burden is on him to show that there was a plausible reason for his change in plans.

⁹⁹ This position puts on the party seeking favorable tax treatment the burden of showing not only that there was a business reason for the transaction, but also that there was a business reason for choosing the favorable tax route as against less favorable routes. See *Shaw Construction Co. v. Commissioner*, 323 F.2d 316 (9th Cir. 1963).

¹⁰⁰ This problem was dealt with in *F. C. Publication Liquidating Corp. v. Commissioner*, 304 F.2d 779 (2d Cir. 1962), which involved the acquisition of a corporation having a loss carry-over. The acquiring taxpayer "contended in the Tax Court that although the tax loss carry-over was considered, the principal motivation was that it was felt to be a good opportunity to get into a new area of magazine publishing which would produce considerable revenue." *Id.* at 780. The taxpayer strongly urged that "the risk of loss in the transaction is too great compared with the possible tax gain, and that responsible business people do not take such chances, so that the principal purpose

that tax aspects ordinarily can be easily translated into dollar terms, while other considerations frequently cannot be readily quantified. Nevertheless, a determination of primacy among objectives ought not to ignore dollar magnitudes, no matter how rough and vague the comparison has to be. Common sense tells us that the strength of a tax reduction goal undeniably is greater when the saving is in the millions rather than in the hundreds of dollars.

A third question is whether evidence that the acquirer had the tax advantage in mind ought to be taken into account in weighing the relative importance of the tax and the non-tax purposes. The mere fact that he was interested in the tax benefit should not matter, for if it did, as noted earlier, we would be penalizing the knowledgeable person and rewarding the ignorant. But evidence that the acquirer regarded the tax benefits as having high importance surely is entitled to great weight in ascertaining whether enjoyment of the favorable tax aspects of the transaction constituted the principal purpose.¹⁰¹

A fourth question is what significance should be attached to evidence that the acquirer did not know of the potential tax advantage associated with the acquisition. While such evidence tends to show that the acquirer had no important tax purpose,¹⁰² it is likely to be self-serving. Moreover, it does not foreclose the possibility that although the acquirer was unaware of the tax benefit at the start of the transaction, he learned of it before completion.¹⁰³ And there is always the possibility

cannot have been the tax gain." *Ibid.* The court responded: "A fairly strong case is made that the possible gain from tax savings is disproportionately small. The balance of the argument, however, has its weaknesses. Business people, even very successful business people, do make mistakes, particularly where an apparently effortless gain from the Government is in sight. An equally permissible inference which may be drawn from the evidence is that a business error was made, that the cost of carrying on [the planned] project was underestimated, and the certainty of the loss allowance was viewed too sanguinely. Most important, the testimony and contemporaneous writings of the petitioner's editor make it quite plain that the anticipated tax result was the prime factor in the acquisition." *Id.* at 780-81.

¹⁰¹ In *James Realty Co. v. United States*, 280 F.2d 394 (8th Cir. 1960), involving the issue whether multiple surtax exemptions would be allowed in a multiple corporation setup, the court placed emphasis on testimony that "a great deal of consideration was given to taxes" and that the parties "were very careful to keep the [taxable income] figures under [the level of surtax exemption]." *Id.* at 397.

¹⁰² See *Baton Rouge Supply Co.*, 36 T.C. 1, 14 (1961), where an asserted absence of knowledge of a loss carry-over at the time of acquisition was treated as a strong factor in the taxpayer's favor.

¹⁰³ In establishing a business purpose, the parties may advance their cause by showing that the transaction was conceived before the tax advantages were known to them. Thus, in *The Esranco Truck Co.*, 22 CCH Tax Ct. Mem. 287 (1963), involving § 269 of the Code, the Tax Court attached significance to the fact that an attorney had first advised setting up three corporations rather than one in order to limit tort liability, and then had "consulted with [the client's] . . . accountant as to whether there would be any disadvantageous

that the acquirer's ignorance was itself induced by his interest in being able to make out a case that tax reduction was not his purpose. In the more extreme situations we might treat ignorance by design as the equivalent of knowledge.

Looking at all four questions together serves to underscore an important and by now familiar point. Although in these tax avoidance controversies the conclusion often is framed in what appear to be state of mind terms—that is, we say that in taking a particular action a person did or did not have a non-tax purpose or a tax avoidance motive—the battle is seldom fought on state of mind grounds. Rather, the usual approach is to focus the analysis on whether any non-tax goals or functions were or plausibly could have been served by the action.¹⁰⁴ Sometimes we ask for a showing that one in the actor's position could reasonably have believed that an asserted non-tax objective would be served by the course of conduct. But only infrequently do we pay much attention to whether the actor himself really had a certain non-tax objective in mind when he engaged in the transaction.¹⁰⁵ All in all, the role of

tax consequences by forming three corporations. Upon the accountant's assurance that the tax consequences were favorable rather than unfavorable, the plan was executed." *Id.* at 294.

But compare the thought advanced by the Tax Court in another case: "We are concerned here with [the acquiring party's] . . . principal purpose in acquiring all of the [acquired corporation's] . . . stock at the time the transaction was closed—not with his purpose in entering into the entire transaction at the time he first discussed it with [the prior owner of the corporation] . . . and looked over the property. Of course his initial purpose in entering into the transaction might well have considerable bearing on his reasons for acquiring [the] . . . stock but it is not necessarily determinative of his purpose in buying [the] . . . stock. He may have had one purpose for entering into the transaction and another purpose in carrying it out in this manner." *The Huddle, Inc.*, 20 CCH Tax Ct. Mem. 745, 748-49 (1961).

¹⁰⁴ The asserted business reasons must be plausible under the circumstances of the particular case. Thus, the Tax Court, in commenting on the business purposes that were claimed to have been served by using multiple corporations in the development of a real estate subdivision, said: "We are convinced . . . from our study of all the facts and circumstances that none of the alleged advantages in the use of multiple corporations . . . constituted any actual business purpose in the instant case. The alleged business purposes impressed us simply as a lawyer's marshalling of possible business reasons that might conceivably have motivated the adoption of the forms here employed but which in fact played no part whatever in the utilization of the multiple corporation structure." *Aldon Homes, Inc.*, 33 T.C. 582, 597-98 (1959).

¹⁰⁵ Occasionally, courts appear to insist that the asserted business purpose must have activated the transaction in question. For example, in *Weyl-Zuckerman & Co.*, 23 T.C. 841 (1955), the Tax Court said: "Moreover, the requisite business purpose or intention must be established by evidence; it is not enough for counsel to theorize as to what the intention might have been. It must be shown by satisfying evidence that the alleged business purpose was in fact entertained as a motivating factor by petitioner or its responsible representatives; a possible business purpose conceived after the event in order to give color to the transaction cannot retroactively supply the required bona fides which might otherwise be lacking." *Id.* at 847.

any state of mind inquiry is very much smaller than the rhetoric might seem to suggest.¹⁰⁶

What emerges is that an anti-tax avoidance principle tends in practice to resemble a comparative relatedness test. Often the critical question, in effect, ultimately becomes: How close is the relationship that can be seen between action of the kind taken and the asserted non-tax objectives?¹⁰⁷

¹⁰⁶ A "business purpose" test may be of either an objective or a state of mind nature. In the objective version the inquiry essentially is whether the particular transaction came close enough to our model of what a reasonable businessman would have done under the circumstances. In the state of mind version the inquiry is whether the actor actually believed he was acting for business reasons—even if in so doing he failed to live up to our standards of reasonable business conduct.

An instructive sidelight on the relationship between state of mind inquiries and administrative limitations is found in an extraordinary pocket of the law: "Section 367 of the present Code provides that in an attempted tax-free exchange involving a foreign corporation, the latter will not be regarded as a corporation unless prior to the transaction the Commissioner was satisfied that the exchange did not have as one of its principal purposes the avoidance of federal income tax. The National Office of the Internal Revenue Service, which processes applications for determinations by the Commissioner that the requirements of section 367 are satisfied, has no facilities for pursuing an inquiry into the subjective purposes of the taxpayer. It may therefore be speculated that the administrative application of section 367 replaces the subjective criterion of the statutory language with a standard based on the demonstrable results that may be expected from the proposed tax-free exchange and transactions that might follow." Fuller, *Business Purpose, Sham Transactions and the Relation of Private Law to the Law of Taxation*, 37 TUL. L. REV. 355, 391 (1963).

¹⁰⁷ It never is very productive to ask whether the taxpayer was acting pursuant to a tax avoidance motive. The acknowledged presence of a desire to reduce taxes may call for paying greater attention to ascertaining whether a non-tax objective was also in the picture and to assessing the significance of such an objective. Perhaps this is what is behind the frequently voiced thought that when the scent of tax avoidance is in the air, the transaction in question should be subjected to greater than usual scrutiny.

It is instructive to note the Australian experience with a statutory catch-all, anti-tax avoidance rule that provides: "Every contract, agreement, or arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act, shall so far as it has or purports to have the purpose or effect of in any way, directly or indirectly—(a) altering the incidence of any income tax; (b) relieving any person from liability to pay any income tax or make any return; (c) defeating, evading, or avoiding any duty or liability imposed on any person by this Act; or (d) preventing the operation of this Act in any respect, be absolutely void, as against the Commissioner, or in regard to any proceeding under this Act, but without prejudice to such validity as it may have in any other respect or for any other purpose." Income Tax and Social Services Contribution Assessment Act 1936-1950, § 260, 3 COMMW. ACTS 1901-1950, at 2254-55 (1953) (Austl.).

A commentator summed up the judicial treatment of this provision as follows: "[I]t is suggested that the proposition laid down [by the Privy Council in a leading case] . . . cannot be considered as any mechanistic test for "purpose," indeed scarcely a test at all, but little more than an injunction to the courts to exercise discrimination in the application of the section. Those arrangements which possess a *prima facie* plausibility, i.e., are capable of explanation by reference to any dealing which has no purpose of avoiding

V

By now it should be readily understood why conscientious tax administrators might have conflicting attitudes toward rules that seek to classify actions on the basis of purpose. One attitude is commonly displayed in the case of rules under which tax consequences turn heavily on the form in which a transaction is cast. The inclusion of a purpose test in such a rule is applauded because it reduces the ability of taxpayers to manipulate the forms so as to secure tax advantages and thus limits those advantages to the "deserving" situations.¹⁰⁸ An altogether different attitude on the part of the administrators is sometimes evident in the case of rules that look to the actor's principal purpose but do not

tax, are to be distinguished from those which in the light of their effect on tax liability are so blatant or outrageous that a purpose of avoiding tax is patently obvious on the face of the arrangement. The rule is little more than the recognition of a judicial discretion to determine and strike down "obvious" attempts at tax avoidance, yet to so delimit the sphere of operation of the section as to leave untouched transactions occurring in the normal flow of business or family affairs whether or not these transactions have the effect of avoiding tax, and whether or not they are animated by this purpose." Trebilcock, *Section 260: A Critical Examination*, 38 *AUSTL. L.J.* 237, 242-43 (1964).

Section 138 of the Canadian Income Tax Act provides: "Where the Treasury Board has decided that one of the main purposes for a transaction or transactions . . . was improper avoidance or reduction of taxes that might otherwise have become payable under this Act . . . the Treasury Board may give such directions as it considers appropriate to counteract the avoidance or reduction." CAN. REV. STAT. c. 148, § 138 (1) (1952). Study No. 22 for the Royal Commission on Taxation notes that this provision appears to suffer from several weaknesses, including: "(a) The intention of the taxpayer must be considered. . . . This is a subjective test and difficult to apply. (b) It is unreasonable to blame a taxpayer for taking taxation factors into account in managing his property when, quite independently of this factor, the transaction or transactions in question are in accordance with normal business practice. (c) The provision implies that there are proper ways of avoiding tax and that in such cases the provision cannot be invoked. . . . The legislature has thus taken pains to point out that tax avoidance may be improper without necessarily contravening any other provision of the Act. At the same time, however, the Act gives no definition of what is meant by the words 'improper avoidance or reduction of taxes.'" ROYAL COMMISSION ON TAXATION, STUDY No. 22, pp. 358-59 (1964). The Study recommends that: "The Income Tax Act should contain a provision to the effect that in computing tax all artificial transactions which have the effect of reducing the amount of tax payable should be disregarded. Such transactions should be defined as transactions which while legally valid are contrary to normal business practice or would be contrary to normal business practice if their purpose were not to reduce the tax payable." *Id.* at 363.

See also LAPIDOTH, *EVASION AND AVOIDANCE OF INCOME TAX: A COMPARATIVE STUDY OF ENGLISH LAW AND ISRAELI LAW* (1966).

¹⁰⁸ See Paul, *Motive and Intent in Federal Tax Law*, in *SELECTED STUDIES IN FEDERAL TAXATION* 255 (2d ser. 1938). The inclusion of a state of mind element in a rule does, however, tend to increase "uncertainty" and to reduce "predictability" by widening the range of factors that are relevant to classifying an action. See Blum, *Some Off-Center Observations About Our Tax System*, N.Y.U. 16th INST. ON FED. TAX 1 (1958).

rely heavily on form.¹⁰⁹ The results under these latter rules often are very likely to turn on a combination of the point that in "close" situations there is a tendency to regard the test as calling for an overall impressionistic judgment, and of the point that the taxpayer by and large is in command of telling the story and creating evidence for the record. The taxpayer can be expected to testify that his action was associated with a purpose that qualifies for advantageous tax treatment. The argument in opposition must in most instances rest heavily on inferences drawn from the action itself or from weaknesses detected in the taxpayer's assertions. With affairs in this posture, a strong showing of any qualifying purpose will often carry the day for the taxpayer—even though an uncovering of all the facts would have revealed another purpose as primary. Thus, a primary purpose test frequently turns into a significant purpose test, with the taxpayer in control of the presentation.

In areas where the results seem to depart too often from what he views as the realities, a reflective tax administrator understandably might seek to replace a purpose test with a rule of classification based on the action itself. For example, not long ago, at the urgings of revenue officials, the statutory provision for dealing with travel fares in the case of combined business and pleasure trips was markedly altered, though only for a brief time.¹¹⁰ The old language, which had been implemented by a principal purpose test, was changed to provide for an allocation of the fare between business goals (which qualified for deduction) and non-business objectives (which did not qualify), the apportionment to be on the basis of the relative amount of time spent during the trip on the various pursuits.¹¹¹ The new test was largely repealed before it was put into operation—apparently for reasons mainly political.

Another illustration, taken from the realm of litigation rather than legislation, concerns the unusual question of the deductibility of legal fees incurred by a husband in connection with incompetency proceedings instituted by his wife. In *Lewis v. Commissioner*,¹¹² the taxpayer,

¹⁰⁹ A cynical view is that administrators usually find vagueness in any area to be highly congenial. Ambiguity in a governing rule confers power on them and precludes effective criticism of their actions. Thus, vagueness makes their jobs more interesting and, from their point of view, perhaps more important.

¹¹⁰ INT. REV. CODE OF 1954, § 274(c), prior to amendment by P.L. 87-272, § 217(a).

Every transaction that has business and personal aspects could in theory be divided into these two components. However, this would be impossible from an administrative standpoint in most situations.

¹¹¹ Under the Regulations the amount of time spent in business and non-business pursuits is an important factor in determining whether a combination business and personal trip is primarily business or personal in nature. Treas. Reg. § 1.162-2(b)(2) (1958).

¹¹² 253 F.2d 821 (2d Cir. 1958).

an author and publisher, argued that because an adjudication of incompetency would have been extremely detrimental to the sale of his books, his legal fees were business expenses incurred to protect his profitable business from destruction. The Government argued that the fees were personal in nature. The Tax Court characterized the expenses as personal, on the ground that "the taxpayer's foremost concern [in contesting the incompetency proceedings] was with his personal liberty rather than the protection or control of his property"¹¹³ The court of appeals, although it agreed with the Tax Court's conclusion, rejected this approach, observing that the fact "that one taxpayer prizes his liberty more highly than his property, while another values property more highly, seems to us irrelevant to the allowance of a claimed deduction."¹¹⁴ It thought that the expenditure should be classified on the basis of whether "the charge that the taxpayer was incompetent was . . . directed at destroying his trade or business . . . [or] was directed at the totality that is the individual."¹¹⁵ Under this test, said the court, the "taxpayer's motivation is not . . . relevant."¹¹⁶ But the language used left a possible doubt whether the opinion was laying down a flat conclusory type of rule (that is, incompetency proceedings are always personal in nature) or a comparative relatedness rule (that is, the result in each case is to depend on whether the particular incompetency proceeding was related more to business or to personal affairs). The court referred to what the particular incompetency charge had been "directed at." In future cases this wording could be construed as calling for an examination of all the circumstances leading up to the bringing of the charge, including the reasons activating the wife or other moving party. More likely, however, the phrase will be viewed as stating the conclusion that by their very nature charges of incompetency go to the individual as a whole person rather than to him as merely a businessman.

A very recent illustration of the reaction of tax administrators to a principal purpose test, taken from the realm of administrative regulations rather than of legislation or litigation, concerns an area that we have already used as an illustration—the deduction of expenses for education within an undergraduate or graduate degree program. Existing Regulations contain the general rule that expenditures made by a taxpayer for his education are deductible if the training is undertaken primarily for the purpose of maintaining or improving skills required by him in his present employment or other trade or business¹¹⁷—a

¹¹³ 27 T.C. 158 (1956).

¹¹⁴ 253 F.2d 821, 825 (2d Cir. 1958).

¹¹⁵ *Id.* at 825.

¹¹⁶ *Id.* at 826, n.5.

¹¹⁷ Treas. Reg. § 1.162-5 (1958).

position elaborated in a ruling which states that "the fact that . . . a degree . . . may result does not preclude a deduction. . . ."¹¹⁸ Proposed Regulations, withdrawn in favor of Amended Proposed Regulations, would have denied deductibility if the training were undertaken "as part of a program leading to attainment of a recognized level of education"; and they would have specifically included in this non-deductible category any expenditures for education "which of itself, or when combined with education previously taken (or to be taken) will qualify the individual for a degree, diploma, or similar certificate"¹¹⁹ What would have been the thrust of this proposed change can be seen by again considering that old friend, the accountant who pays his way through a full undergraduate course of study in law school. Instead of being able to argue for deductibility of his tuition on the ground that he had enrolled to become a better accountant, he presumably would have been denied a deduction because he had undertaken a program leading to a law degree.¹²⁰

Such an approach must meet one crucial challenge: Is it defensible to deny deduction of tuition where the accountant's only thought in attending law school was to become a more skilled accountant and where in fact he remains in accounting practice throughout his professional life? The result of denying a deduction under these circumstances is that a cost which is incurred exclusively in connection with an existing trade is never counted as an expense of pursuing that trade. But that consideration alone should not be conclusive, since we must recognize that precision in measuring net business income sometimes comes at too high a price. The decisive question in shaping policy in these situations should be whether the increase in the crudeness of measuring income is more than offset by the elimination of such shortcomings in the primary purpose test as heavy administrative costs, classifications that in the light of hindsight seem to be wrong, and a

¹¹⁸ REV. RUL. 60-97, 1960-1 CUM. BULL. 69, 71.

¹¹⁹ Proposed Amendments of Regulations, published in the Federal Register on July 7, 1966, 31 Fed. Reg. 9276 (1966), amending § 1.162-5. This proposed change in the Regulations may have stemmed not from difficulties experienced in administering the principal purpose test, but rather from a conviction that the basic rule is wrong in failing to recognize that training to advance one's existing career pattern is more in the nature of a capital expenditure than a business expense.

¹²⁰ In the entertainment expense area great difficulty was encountered in trying to distinguish between deductible business entertainment and non-deductible social entertainment on the basis of the taxpayer's reasons for entertaining. Legislative changes in 1962 put the emphasis on the circumstances surrounding the entertainment instead of on the taxpayer's purpose. See INT. REV. CODE OF 1954, § 274(a). The Regulations implementing this legislation now provide: "An objective test shall be used to determine whether an activity is of a type generally considered to constitute entertainment." Treas. Reg. § 1.274-2(b)(ii) (1963).

relatively large potential for highhanded or even fraudulent arrangements. To this question, no blanket answer is possible, for we are likely to balance the scales differently as we move from one tax issue to another.

VI

But will the adoption of a classification by action rule, whether of a conclusory or of the comparative relatedness type, eliminate all inquiry into state of mind? If, for example, the proposed (but withdrawn) regulations on the expenses of education had become law, would there no longer have been any need to consider the state of mind of a practicing accountant who took undergraduate courses in law school? The answer may well be that we cannot altogether avoid paying attention to the thoughts that accompany such actions. Suppose our accountant had enrolled in law school as a student-at-large and had first taken courses in taxation, then in trusts and estates, then in corporations, and so on, until he finally had received a degree in law. How would his tuition expenses have been handled under the Proposed Regulations? The cost of the first few courses, standing alone, seemingly would have been deductible, since they almost certainly could not have been termed either capital or personal expenditures; moreover, they undoubtedly had served to maintain or improve skills "required by the individual in his present employment or other trade or business." But we would have had to decide whether these first courses were to be viewed as standing alone or whether they were to be "combined with education . . . to be taken" later, in which case they might not be deductible. It is this challenge that makes complete escape from state of mind considerations unlikely and perhaps impossible. Is there any way we can avoid looking into whether, in the early stages of his law work, the accountant planned to take only a few courses that had a bearing on accounting work, or whether he had a preconceived plan to embark on a program leading to a law degree? And if in those early stages he was undecided, is there any way we can sidestep the usual ambiguities inherent in a purpose test—including the question whether principal purpose, a major purpose, or a significant purpose is to control?

Although under the proposed regulations on education expenses any residual state of mind ingredient would at most have been a triviality, in a more generalized version the point illustrated is basic and far-reaching. In many areas of tax law—ranging from adjusting ownership of business interests to reallocating wealth among members of a family—we face the question whether the various moves in a series of more or less related actions are to be viewed separately or are to be classified

only after being consolidated in some fashion.¹²¹ Usually, the tax administrators argue that related steps should be consolidated, while the taxpayers insist that they be kept separate. But the positions are not uncommonly reversed.¹²² In either event, whenever there is a possibility of integration, the role to be assigned to a state of mind inquiry may come into issue. This is seen if, to facilitate analysis, we assume the existence of an explicit rule that in classifying certain types of actions a determination is first to be made whether each is to stand alone or is to be consolidated with related actions. What tests can we use to make this determination, other than an inquiry into the thoughts of the actor, or of a hypothetical average actor, before and during the time the various steps were taken?¹²³ Two major possibilities, both already anticipated, should be observed.

One is to ignore completely all state of mind considerations and to ask instead whether from outward appearances the timing and manner of accomplishing the related actions more strongly suggest a single program or a disjointed set of moves.¹²⁴ This in essence amounts to a version of the comparative relatedness test. In the case of the accountant

¹²¹ The integration versus separate steps issue arises in the context of several different patterns, among which are the following:

1. At the end of a given step, the taxpayer's action ostensibly fits into a certain classification. Can a later step be treated as part of the action in question to bring about a different classification?
2. The taxpayer's action ostensibly fits into a certain classification. Can an earlier step be treated as part of the action in question to bring about a different classification?
3. A number of separate actions by the taxpayer ostensibly fit into a certain classification. Can these actions be viewed as a single transaction to change that classification?
4. An action by the taxpayer ostensibly fits into a certain classification. Can this action be viewed as a set of separate transactions to change that classification?

¹²² For a recent case in which the taxpayer unsuccessfully sought to have several steps viewed as a single integrated transaction, see *John Town, Inc.* 46 T.C. 107 (1966).

¹²³ The Revenue Service will give advance rulings on some issues only where there are representations that no "concerted plan" is contemplated. In this setting the integration issue must depend on state of mind. See Rev. Proc. 66-34.

¹²⁴ Regarding the importance attached to the time interval between steps, it has been observed in the area of corporate reorganizations: "It is generally agreed that the unity of steps is not dependent upon how closely they follow one another in time. The temporal relationship is merely one scrap of objective evidence assisting the courts in applying whatever other test they deem pertinent. If steps occur within a matter of hours, the fact that the second step could hardly have been conceived and executed in the interval following the first is persuasive evidence that they were prearranged, whereas the passage of a few months or years predisposes a court to find that the later step was a mere afterthought. On the other hand, where other evidence points to a connected plan and the delay is adequately explained, the courts have integrated steps which were as long as six years apart; and, upon appropriate findings respecting the freedom of action of the parties, steps taken half an hour apart have been held to be independent." Mintz & Plumb, *Step Transaction in Corporate Reorganizations*, N.Y.U. 12th INST. ON FED. TAX 247, 249 (1954).

enrolled as a student-at-large in law school, for example, we would ask whether, as of a certain time, his pattern of taking courses more closely resembled a degree program in law or a form of add-on training for accountants. To make this comparison, we would need to consider the usual schooling pattern for getting a law degree on a stretched-out program and that for expanding skills as an accountant. The process would not be very satisfactory unless some predominant patterns were to emerge—an unlikely prospect in the area of professional education.

The other possible type of test would focus on the internal relationships among the various steps. The inquiry would delve into whether it was rational for the taxpayer to take the earlier steps assuming he did not plan also to take the later ones;¹²⁵ or, in another version, whether the moves were interdependent to such a degree that taking the earlier steps would have been fruitless unless the subsequent steps were also taken;¹²⁶ or, in still another version, whether the steps were so closely tied together that the taxpayer could not stop short of completing all of them without suffering inhibiting losses. Thus, in the illustrative situation we would consider whether, if the taxpayer had stopped short of fulfilling the requirements for a degree in law, his training up to the cut-off point would have advanced his career as an accountant. We would be looking for something like a point of no return—a point after which the taking of additional law courses does not harmonize with improvement of accounting skills.

What is noteworthy here is that in theory the results under the three tests in any given situation might not be the same. To illustrate, assume that the accountant started out as a student-at-large, took his courses on an unevenly spaced and timed pattern, and at the outset placed in his files a document revealing that he planned on eventually getting a law degree.¹²⁷ Under a state of mind test he would not be al-

¹²⁵ In the illustrative case of the accountant attending law school, this issue might be phrased in terms of how likely it was that the taxpayer anticipated taking additional courses.

¹²⁶ The court in *ACF-Brill Motors Co. v. Commissioner*, 189 F.2d 704, 707 (3d Cir. 1951), put the test this way: "Were the steps so interdependent that the relations created by one transaction would have been fruitless without the completion of the series?"

Where a transaction involved commitments between two or more parties, this test might be framed in a more colloquial way: If the whole deal had fallen through, would the taxpayer have been able to ignore or undo the early step without subjecting himself to liability? See Paul & Zimet, *Step Transactions*, in *SELECTED STUDIES IN FEDERAL TAXATION* 200 (2d ser. 1938).

¹²⁷ As another illustration, consider the case of an individual who transfers appreciated property to a corporation in exchange for all its stock and who immediately afterwards, in accordance with a previously formed plan, makes a gift of more than twenty per cent of that stock to relatives. The appreciation will be taxed at the time of transfer to the corporation if it is determined that the transferor had an 80% controlling in-

lowed to deduct any part of his tuition fees; under a comparative relatedness or resemblance test he might be able to sustain a deduction for all of them; and under an interrelatedness test he probably could deduct for his early courses in taxation and trusts, but not for his later studies in trial techniques and evidence.¹²⁸

In practice, however, we usually do not differentiate among the tests so sharply, nor do we employ any single approach to the problem for use across the board.¹²⁹ The myriad of classification rules are designed to serve highly divergent policies; and no one of the three types of tests for handling the integration-separate steps issue is likely to best implement all the different policies.¹³⁰ If any other generalization can be supported, it is the not surprising point that we tend to rely heavily on outward appearances where the steps seem to be closely interlocked,

terest in the corporation at that time. INT. REV. CODE OF 1954, § 351. If the transfer of property and the gift of shares are treated as being linked together, the transferor will not be said to have had the requisite control, and the transfer to the corporation will be taxable. The two steps might well be integrated if the test turned on the plan of the transferor; they would not be integrated if the test were either the independent significance of the first step or the freedom of the transferor not to take the second step after completion of the first. See *Wilgard Realty Co. v. Commissioner*, 127 F.2d 514 (2d Cir. 1942), adopting the last mentioned test.

¹²⁸ INT. REV. CODE OF 1954, § 265(2), provides that no deduction shall be allowed for "interest on indebtedness incurred or continued to purchase or carry obligations . . . the interest on which is wholly exempt from the taxes imposed by this subtitle." There is no indication on the face of this section whether the taxpayer's thoughts in incurring or continuing the indebtedness are relevant. Suppose that on the first day of a month the taxpayer borrowed a sum of money, putting up his home as security, and that on the last day of that month he purchased the same amount of exempt bonds. Would these facts alone result in denial of a deduction for interest paid the bank, or would denial result only if the two actions (borrowing on the home and purchasing the bonds) were linked in the taxpayer's thoughts?

¹²⁹ In consolidating various steps, courts often speak of the "essential nature of the transaction" without specifying the test used for ascertaining this essential nature. An illustration is provided by the opinion in *Commissioner v. Ashland Oil & Refining Co.*, 99 F.2d 588, 591 (6th Cir. 1938), dealing with the question whether a purchase of stock, followed by a liquidation of the acquired corporation a year later, amounted to a purchase of the acquired corporation's assets: "The question remains, however, whether if the entire transaction, whatever its form, was essentially in intent, purpose and result, a purchase . . . of property, its several steps may be treated separately and each be given an effect for tax purposes as though each constituted a distinct transaction. . . . And without regard to whether the result is imposition or relief from taxation, the courts have recognized that where the essential nature of a transaction is the acquisition of property, it will be viewed as a whole, and closely related steps will not be separated either at the instance of the taxpayer or the taxing authority"

¹³⁰ Two perceptive commentators have written that "the aphorisms about 'closely related steps' and 'integrated transactions' may have different meanings in different contexts, and that there may not be one rule but several, depending on the substantive provisions of the Code to which they are being applied." Mintz & Plumb, *Step Transactions in Corporate Reorganizations*, 12th N.Y.U. INSR. ON FED. TAX 247, 252-53 (1954).

yet we generally take account of the actor's thoughts where it is asserted that they provide a different, less obvious explanation for the pattern of conduct. Consider, for example, a transfer of property to a corporation by its controlling shareholders. Under the statute, if the transfer is a contribution of capital, the corporation succeeds to the tax basis which the assets had in the hands of the shareholders; if the transfer is a sale at fair market value, the corporation takes the sale price as its basis. Suppose that controlling shareholders contribute money to a corporation, and soon afterwards the corporation buys property from the shareholders at a price equal to the property's fair market value and equal to the shareholders' cash contribution. Inasmuch as this is an area in which separate steps are to be consolidated whenever appropriate, the question arises whether the property transfer is to be treated separately as a purchase for cash, or is to be viewed in combination with the cash contribution and therefore as a contribution of property.

In this type of situation, the actions appear to speak for themselves. The close timing of the two steps and the equivalence between the amount of cash contributed and the purchase price seem to preclude separating the two actions; moreover, there seems to be no difficulty in describing the beginning and end of the transaction viewed as a single whole. But, even though in the usual case the result is almost certain to be the same whether or not the thoughts of the shareholders are considered, in the rare case a difference may be expected. Suppose, for example, that the shareholders in fact planned for the corporation to use the contributed cash to purchase other property from outsiders, and immediately afterwards for a good and demonstrable reason they changed their minds. At least in these odd cases, we are reluctant to ignore state of mind and rely exclusively on the appearance of things. This is probably nothing more than another instance of the by now familiar observation that where a rule calls for ascertaining state of mind, we are unlikely to be moved by self-serving statements about mental operations which seem to be refuted by external factors unless the inconsistencies can be satisfactorily explained away.

A distinction should be noted between two aspects of the problem of separate steps versus integration, one being illustrated by the transfer to the controlled corporation and the other by the accountant who enrolled in law school as a student-at-large. Ordinarily, a person cannot use a student-at-large status to accomplish the same non-tax ends that he can satisfy by being a degree candidate. A person can, however, often serve the same non-tax ends either by transferring property to a controlled corporation, or by transferring cash and having the corporation use the cash to buy the property from the transferor. In situations of the

latter variety, the separate steps versus integration issue can be restated as asking whether the form of the transaction is to prevail over the substance. Whenever it is so framed, the question may be regarded as a branch of the more general anti-tax avoidance doctrines discussed previously. By going through a series of related actions as though each were separate, taxpayers may seek only to minimize taxes, or they may seek to accomplish some non-tax objective.¹³¹ An anti-tax avoidance principle, in essence, calls for a judgment whether any sufficiently weighty and relevant non-tax objective was served or plausibly could have been served by the action under scrutiny. Such an approach can also be employed in deciding whether a series of actions is to be subjected to a test for consolidation. Under that approach, the actions always would be treated as separate, even though they were part of a plan, if there had been a good enough business or other acceptable non-tax goal to be served by the course taken; and in the absence of such a goal, the applicable test would be brought to bear in deciding whether under the facts of the particular case a consolidation of the steps was in order. But we should again note that, although it may be readily stated in terms of motive and purpose, such an anti-tax avoidance principle is likely

¹³¹ Omitted from the text is any mention of such terms as "sham," "mere artifice," etc. These reprobative labels, which seldom aid in analysis, are used in various ways. They are sometimes used to characterize actions that are different from what they purport to be because of secret agreements or false documents. They are also used to describe contrived actions which do not deviate from their outward appearances, but which cannot have any consequences other than the attainment of otherwise unavailable tax advantages. One might question whether there is any difference between such "sham" actions and other actions that have tax reduction goals but no non-tax objectives. A recent attempt to distinguish the two was made in *Goldstein v. Commissioner*, 364 F.2d 734, 742 (1966): "In many instances transactions that lack all substance, utility, and purpose, and which can only be explained on the ground that taxpayer sought an interest deduction in order to reduce his taxes, will also be so transparently arranged that they can candidly be labeled 'shams.' In those instances . . . the rationale of the decision we announce today [that the borrowing must serve a purpose other than reducing taxes] . . . [is] available as grounds for disallowing the deduction. The present case makes plain, however, that these rationales are distinct from each other, and that a court need not always first label a loan transaction a 'sham' in order to deny a deduction for interest paid in connection with the loan."

In dealing with the integration versus separate steps problem, a distinction is sometimes made on the basis of whether each step had "substance," or whether some of the steps amounted to mere paper shuffling that lacked "substance." Thus, in *Chamberlin v. Commissioner*, 207 F.2d 462, 471-72 (6th Cir. 1953), the court noted: "The facts in this case show tax avoidance, and it is so conceded by petitioner. But they also show a series of legal transactions, no one of which is fictitious or so lacking in substance as to be anything different from what it purports to be. Unless we are to adopt the broad policy of holding taxable any series of transactions, the purpose and result of which is the avoidance of taxes which would otherwise accrue if handled in a different way, regardless of the legality and realities of the component parts, the tax assessed by the Commissioner was successfully avoided in the present case."

in operation to play down state of mind considerations and to build mainly on external factors that indicate the significance of non-tax goals.

We have been assuming situations in which the law calls for determining whether several steps are to be viewed as independent or are to be integrated. In some areas, however, the law in classifying actions does not require consolidation of interrelated steps even though they were taken separately solely in order to reduce taxes.¹³² Form is deliberately permitted to control, so that the result will turn on the tax consequences of each step rather than on those of the whole operation. To illustrate, suppose a taxpayer owning stock that has increased in value sells his shares through a broker and simultaneously buys through the broker the identical number and class of shares in the same corporation. Rather than combine the sale and purchase steps so as to treat the shareholder as having retained his original shares, we tax his gain and regard him as having entered into a wholly new transaction—even if he admits that he planned not to alter his investment position and that he wanted only to realize a gain in order to offset a loss already sustained during the year.¹³³ Where form is thus automatically accepted, there is no occasion for an inquiry into motive or purpose. But in most areas of taxation form is not treated as decisive, and hence we need to ask how one can pick out the rules under which form is always to govern.

A short answer is that there can be no universal guide to identifying the rules under which form is to control. Resolution of each form versus substance issue requires consideration of the policy or policies to be served by the particular part of the law which is in question; and in searching for guidelines, the values of adhering to form may themselves be regarded as a matter of policy.¹³⁴ We frequently speak of this process as looking for the intent of the legislature. Such a perspective may or

¹³² Consider, for example, a corporation that owns an 80% controlling interest in a subsidiary and has a loss on its investment in the subsidiary shares. Shareholder losses in liquidation of controlled subsidiaries are not recognized at the time of liquidation. In *Granite Trust Co. v. United States*, 238 F.2d 670 (1st Cir. 1956), the parent, in order to have its loss on liquidation of the subsidiary recognized, sold immediately before liquidation enough of its shareholdings in the subsidiary to get below the 80% controlling interest line. The stratagem was allowed to stand.

¹³³ "Wash" losses are not allowed. INT. REV. CODE OF 1954, § 1091. There is no counter-part provision in the case of "wash" gains.

¹³⁴ A good illustration is furnished by the incorporation of a business. The owner is entitled to all the tax advantages of incorporation even though he incorporated only to get those advantages.

With respect to the question whether corporate form is to be disregarded, the Supreme Court has said that "so long as [the] purpose [in using a corporation] is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 439 (1943).

may not be helpful. But what merits note here is that this sifting for policy cannot be advanced by looking to the motive, intent, or purpose of any or all of the participants in a particular transaction whose tax consequences are in doubt.

VII

We come at last to the perplexing question of what constitutes the outer limits of meaningful state of mind inquiries in taxation. There are rules that seem to deal with motive or intent, but do so in oblique ways. These rules provide an opportunity to speculate about the possible boundaries of useful state of mind probes.

An inviting area for exploration involves the question, frequently encountered in connection with closely held corporations, of when instruments or contracts which in form reflect a corporate indebtedness are to be treated as investments in the equity.¹³⁵ One obvious role here for a state of mind inquiry should be mentioned and then put aside. If those who own and control the corporation have an undisclosed understanding that they will ignore the terms of the ostensible debtor-creditor relationship, their secret plan is to be taken into account in classifying the pieces of paper. "It is always open to the Commissioner to prove that the transaction is not what it appears, [but] . . . that the parties truly intended to and actually did enter into another and hidden agreement by which their rights are to be governed."¹³⁶

Several other state of mind inquiries for resolving the debt-equity question are suggested by examining the various opinions in the *Gilbert* litigation. The Tax Court initially found that one of the investors

¹³⁵ Another problem which tests the usefulness of the state of mind factor is whether a family partnership is to be recognized in ascertaining the proper taxable persons. The Supreme Court has taken the position that tax recognition of partners in a family partnership formed by gifts of capital depends upon whether the partnership was formed "in good faith . . . with a business purpose." *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949). The Regulations that implement § 704(e) of the Code, which was designed to provide objective guidelines for determining the allocation of income in the case of family partnerships, list the intent of the parties as one of the factors to be considered in determining whether there was a complete transfer of capital to the donee-partner. *Treas. Reg. § 1.704-1(e)(3)(i)(b)* (1956). This formulation is not clear. If the point is that we are to look behind the formal documents to take account of any hidden understandings that vary the terms, it is of course correct. But there seems little justification for insisting that a gift of an interest in a partnership to a close relative must have been accompanied by a business purpose before the income derived from the capital element in the transferred interest will be taxed to the donee. See *Henry S. Reddig*, 30 T.C. 1382 (1958).

¹³⁶ *Gilbert v. Commissioner*, 248 F.2d 399, 402 (2d Cir. 1957). In *Gooding Amusement Co.*, 23 T.C. 408, 418-19 (1954), the Tax Court put emphasis on whether "the noteholders intend to enforce payment of their notes or assert the rights of bona fide creditors." This approach led the court to consider "the real intention of the parties."

"had an intention, although it was vague and not based on valid reasoning, that her advances to [the corporation] should be loans and this intention was acquiesced in by the corporation" ¹³⁷ It might have been relevant to consider what rights the investors intended to create among themselves and with respect to other parties by having the corporation purport to contract an indebtedness. But, as was earlier noted in looking at the definition of gifts that are excludable from income, it is unsound for a court to resolve such an issue by ascertaining what classification was sought by the taxpayer, since the very question in dispute is whether the facts in the case are to be treated as coming within that classification. ¹³⁸ Moreover, as the court of appeals pointed out the first time it reviewed the *Gilbert* litigation, there is error in the view

¹³⁷ Benjamin D. Gilbert, 15 CCH Tax Ct. Mem. 688, 694 (1956).

Earlier in the development of the distinction between debt and equity in the tax field, courts paid considerable attention to whether the parties intended to create a debt. In *Alma de Bretteville Spreckels*, 8 CCH Tax Ct. Mem. 1113, 1117 (1949), for example, the court said: "These circumstances relied upon by respondent are not sufficient to constitute [*sic*] the advances a contribution to capital if the real intention of the parties was that the advances should constitute loans, for the intention is the controlling factor, and where the *bona fides* is not questioned (as here), the facts that the lender was the sole stockholder and the corporation's business was not prospering are not a basis for disregarding the true intention or the right of the parties to create debts."

In *American-La France-Foamite Corp. v. Commissioner*, 284 F.2d 723, 724 (2d Cir. 1960), the court, in discussing the distinction between loans and capital contributions, observed: "[I]t is said that 'the intention of the parties is a major factor in determining the relationship' (*Jennings v. United States*, 7 Cir., 1959, 272 F.2d 842, 843). However, 'intention' is often a highly artificial and hypothetical concept because most frequently business ventures originate and are carried on without any clear intent as to tax consequences. If the venture is directed from the start by tax counsel and accountants, it is likely that the advances will be definitely recognizable as loans or capital contributions. . . . In final analysis, it is from [the] composite of all the facts that an attempt must be made to create a probably non-existent intent and to decide in relation to accepted business practices whether the 'loan' pan of the scale is heavier than the 'capital contribution' pan."

¹³⁸ In deciding whether a note represents a bona fide indebtedness in an intra-family situation, tax law generally has followed the legal relationships recognized under applicable private law. Thus, the Tax Court has said: "It must be clearly shown that it was the intention of the parties to create a debtor-creditor status . . . that there existed at the time of the transaction a real expectation of repayment and intent to enforce the collection of the indebtedness." *Estate of Van Anda*, 12 T.C. 1158, 1162 (1949). A few courts have uncritically used comparable language in deciding whether a security having the formal trappings of debt is to be treated as an indebtedness that can sustain an interest deduction. See *Kraft Foods Co. v. Commissioner*, 232 F.2d 118, 122 (2d Cir. 1956), in which the court said: "The parties were competent to contract a debt; if it was their 'purpose' or 'intent' to do so, then they succeeded because they performed consciously and purposely the legal acts that establish a debt."

There are situations, however, in which we apparently accept the characterization placed on a transaction by the participating parties because we believe that the rules are designed to permit the parties to apportion their taxes among themselves. See *David A. Foxman*, 41 T.C. 535 (1964), dealing with the withdrawal of a partner from a partnership.

that "all inquiry ends upon a finding that the obligation actually created will be treated as debt for non-tax purposes" ¹³⁹ This parallels the point that a transfer is not necessarily a gift under the income tax merely because it is a gift under the private law that governs relationships arising out of the transfer.

More instructive was the view of the court of appeals that the distinction between debt and equity rests on a difference in risks, and that "the shareholder's understanding of the degree of risk involved is of course relevant in determining what is in fact the degree of risk involved." ¹⁴⁰ In making the risk analysis, according to the court, "the motives and expectations of the taxpayer are relevant [but] only insofar as they contribute to an understanding of the external facts of the situation." ¹⁴¹ Here, our own assessment of risk is demanded, and inquiry into the state of mind of the participants is useful only insofar as it sharpens our perception of the external facts. Viewed in this light, the motives or purposes of the owners obviously have no direct bearing on the classification issue.

A dissenting opinion, however, argued that the distinction between debt and equity should turn on a different question: "When the [parties] . . . decided to make their advances in the form of debts, rather than of capital advances, did they suppose that the difference would appreciably affect their beneficial interests in the venture, other than taxwise?" ¹⁴² Such a test appears to rest on the participant's state of mind; specifically, on whether he thought that making an investment in debt as opposed to equity form would have appreciable non-tax consequences. It is at this line that the meaningfulness of a state of mind standard is open to challenge. The suggested test does not seem to refer to motive, intent, or purpose in any of the classical senses of the terms noted at the outset; that is, it does not appear to inquire into what legal relationships the individual desired to create, or what he hoped to accomplish, or why he acted as he did in taking debt paper instead of making a clear-cut contribution of equity capital. Rather, the test seems to focus on the taxpayer's level of understanding of business affairs and legal relationships outside the tax field, such as the rights of the parties in voluntary liquidations and bankruptcy proceedings.

As a criterion for taxation, this standard would run into special difficulties. Not only would it tend to penalize the unworldly; but, once announced, it would lead the sophisticated to inform themselves on the

¹³⁹ 248 F.2d 399, 408 (1957).

¹⁴⁰ *Id.* at 407.

¹⁴¹ *Id.* at 407.

¹⁴² *Id.* at 412.

ways in which their arrangements could make differences apart from taxation. Surely, there is little sense in having tax results turn on whether a person put himself in a position to say, truthfully, that his advisors had told him that his arrangements really did entail certain enumerated non-tax consequences.

If the tax consequences of arrangements are to depend on non-tax factors, the preferable course is to ignore the understanding of the participants—other than perhaps as an aid to our own comprehension of the non-tax factors—and to weigh the significance of those factors independently of the participants' thoughts on the subject.¹⁴³

There is a further question here: Can the debt-equity classification scheme ignore motive, intent, and purpose, and instead refer only to the expectations of the actors? Specifically, might the definition of debt be made to turn on whether the investors originally thought that the corporation would be able to pay interest charges and repay the advances within the times specified in the instruments?¹⁴⁴

Difficulties with this criterion soon become apparent if, as is quite likely, not all of the investors shared the same expectations. In connection with taxation of the investors, for example, the test could lead us to regard a round of pay-outs by the corporation as constituting for some investors a return of loaned capital and for others who invested under similar circumstances a distribution of a dividend. There is something amiss in differentiating among investors who admittedly are in the same boat merely because their personality traits are not the same. Why should an optimist be entitled to recover his investment fully before being taxed, while a pessimist is forced to regard his receipts as dividends even though he has not recovered any of his

¹⁴³ An oddity in the debt-equity cases is that the reclassification issue is more likely to arise if the business is a failure than if it is a success. Possibly the best way for a shareholder-creditor to demonstrate that his expectations as to repayment of the debt were realistic is to cause the corporation to succeed.

Note that resolution of the debt versus equity problem is not helped by asking whether the creation of the ostensible debt served a business purpose. See *Toledo Blade Co.*, 11 T.C. 1079 (1948).

¹⁴⁴ It is instructive to compare treatment of the debt versus equity issue with treatment of the question whether an advance by a corporation to a shareholder is to be regarded as a loan (not taxable to the shareholder) or as a dividend (taxable on receipt if covered by corporate earnings and profits). In resolving the latter issue, the key question usually is whether it was the intention of the recipient and of those in control of the corporation to create a debtor-creditor relationship; that is, whether there was an intent on the part of the recipient to pay back the withdrawal and an intent on the part of those in control of the corporation to enforce the obligation. But the question is to be resolved by considering "whether or not the parties demonstrated by their actions that a loan was intended in good faith, rather than a dividend." Toll, *Constructive Dividends*, 1951 U. So. CAL. TAX INST. 211, 229.

investment? In connection with taxation of the corporation, the expectations standard is even less satisfactory. Under it we would have to agree on whose expectations are germane in deciding, for example, whether a round of pay-outs amounts to a deductible payment of interest or a non-deductible distribution of a dividend. Fragmenting this issue, so as to classify each pay-out to each recipient separately for determining the tax position of the company, would be impractical; and it would be equally unreasonable to call upon the corporation, in computing its own taxes, to ascertain the expectation that predominated among all the investors. The whole operation becomes even more unmanageable, and less justifiable, where some of the original investors sell or give their investment position to others not previously associated with the corporation.

These shortcomings might argue for conducting our inquiry into expectations through examining the thoughts of that old standby, the hypothetical typical taxpayer. The trouble with doing so here is that a search for the reasonable man's expectations would be apt to involve nothing more than an assessment of the business risks attending the investment. Once it was found that there had or had not been a sufficient likelihood that the so-called interest and principal obligations would be met on schedule by the corporation, the issue would seemingly be settled. We thus would be using the reasonable man standard not to assess expectations, but rather to assess business risks—an external factor with no state of mind overtones.¹⁴⁵

Suppose, however, that, despite all the drawbacks, we were to adopt a rule that separated equity from debt by referring to the expectations of the actual investors. Could it then be plausibly said that an inquiry into expectations was merely an aspect of an inquiry into purpose?

Such a conclusion might be suggested by our application of the statutory rules stating that operating losses are deductible in ventures carried on for profit but not in ones carried on for personal satisfactions.¹⁴⁶ Hobby activities not infrequently both produce revenue and provide their owners with personal enjoyment. Our main test in these situations is of the primary purpose variety: We ask whether the taxpayer's primary reason (motive, intent, or purpose) in conducting the operation was to make a profit or to gratify his personal desires. This question—

¹⁴⁵ One commentator puts the debt versus equity matter this way: "[T]he essence of the problem in each case [is] whether or not the parties could and did *realistically* expect that cash would be generated from which the loan could be repaid in accordance with its terms." Hickman, *The Thin Corporation: Another Look at an Old Disease*, 44 TAXES 883, 891 (1966). This does not tell us whether the result should be different where the parties "could" have had such an expectation but in fact "did not."

¹⁴⁶ INT. REV. CODE OF 1954, §§ 165(c), 262.

why the actor did what he did—is like other primary purpose or motive questions that were examined earlier. What stands out in these hobby situations is that frequently we pay a great deal of explicit attention to expectations. A key question often is: Did the taxpayer expect that the enterprise as conducted would earn a profit?¹⁴⁷ The answer, though not conclusive, is taken to bear strongly on the taxpayer's primary reason for investing in his hobby.

This relationship between expectations on the one hand and motive, intent, or purpose on the other is, however, of no help in distinguishing between debt and equity investments in closely held corporations. In the nature of things, the investors' expectations regarding the corporation's ability to fulfill its interest and principal obligations cannot provide any sound leads as to the investors' reasons for causing the corporation to go through the motions of taking on an indebtedness rather than accepting contributions of equity capital. For the fact is that the investors' reasons for preferring a debt position to an equity interest were probably not affected by their expectations, if any, about the corporation's capacity to meet a stated schedule for returning the advances. More likely, the investors had their eyes on the tax advantages of debt as compared to equity investments.¹⁴⁸

¹⁴⁷ It is said that the expectation of profit need not be a reasonable expectation when viewed objectively. "The proper test is not the reasonableness of the taxpayer's belief that a profit will be realized, but whether it is entered into and carried on in good faith and for the purpose of making a profit, or in the belief that a profit can be realized thereon, and that it is not conducted merely for pleasure, exhibition, or social diversion." *Doggett v. Burnet*, 65 F.2d 191, 194 (D.C. Cir. 1933). However, external factors usually are assigned a predominant role in ascertaining the taxpayer's expectations. Thus, in *Henry P. White*, 23 T.C. 90, 94 (1954), dealing with a wealthy man who operated a ballistics laboratory at a cost to income ratio of about 12 to 1 over a 17-year period, the court found that there was no profit motive, observing that "anyone of his intelligence, education, and ability, with knowledge of the facts, could not in good faith reasonably have expected or intended to operate his ballistics laboratory profitably."

Will the taxpayer's assertion of profit seeking ever be accepted in the face of a glaring record of losses or of unbusinesslike conduct? In an unusual case a court of appeals concluded that the trier of fact had been wrong in concluding that the taxpayers, Texans in the oil business (and "men of sound business judgment"), could not have engaged in a horse breeding venture with any expectation of profit: "The breeding of horses would not be considered merely a fad in Texas. It is not at all improbable that men in the oil business, having ample capital, would engage in the enterprises here involved with the hope and expectation of ultimately making a fair return on the investment." *Farish v. Commissioner*, 103 F.2d 63, 65 (5th Cir. 1939).

Compare *United States v. Morgan*, 321 F.2d 781 (5th Cir. 1963), involving the question whether the expectations of the taxpayer or of ordinary prudent persons dealing in mineral lands or mineral leases are relevant in deciding whether a certain receipt is an "oil payment" or a "royalty."

¹⁴⁸ Purpose or intent proved not to be useful for distinguishing between employee stock options that were intended as compensation and those that were intended to give the executive a proprietary interest in the corporation. Since any stock option has strong

In the end, a rather simple point emerges. If we are to distinguish between debt and equity in the hands of the owners of closely held corporations, the only realistic standard is one that turns on the degree of risk attending the investment. Such a standard calls for determining whether the investment is more like an equity risk or a creditor risk—a test of the comparative relatedness type. The expectations of the actual investors regarding corporate earnings and pay-outs may assist in evaluating the riskiness of the investments. But these expectations are not likely to tell us anything about the investors' reasons for putting the investment in debt form; in any event, those reasons should have little bearing on the classification of the investment under the tax law.¹⁴⁹

compensatory aspects, it is unrealistic to pin a large tax difference on the corporation's "reason" for granting the option. See *Commissioner v. LoBue*, 351 U.S. 243 (1956).

In the case of a gift of shares to a family corporation, can an inquiry into the transferor's state of mind be used to draw a distinction between a gift to the corporation and a gift to the other shareholders? In *Estate of Hitchon*, 45 T.C. 96, 104 (1965), a concurring judge said: "Once it is determined that a gift was intended, I would hold that such a transfer by a stockholder to a corporation is a gift to the other stockholders [followed by a pro rata contribution to capital by all the stockholders] . . . I do not agree that there is a difference, in these circumstances, between a transfer by a stockholder to a corporation of its own shares and a transfer of other property, allegedly based on the theory that in the former case there is a proportionate increase in the interests of the other stockholders while the latter case involves merely an increase in the value of the stockholders' existing interests." A dissenting opinion argued that the transfer was not a gift to the other shareholders because "no gifts to [them] . . . were intended." *Id.* at 105.

Suppose that Mr. A, the sole or dominant stockholder of a corporation, surreptitiously takes funds out of his corporation. Is this a dividend, or is it something else? "The pivotal question is whether the \$100,000 taken by Mr. A represents a distribution in respect of his X corporation stock Whether the money was a distribution or not is determined in part by the intent of the X corporation The question when applied to the cases that develop in this area is meaningless. Neither Mr. A, nor his counterparts in the litigated cases were thinking of the formal and mechanical words of the Internal Revenue Code when they took their corporate funds. They owned all of the corporate stock; they were in complete control of their respective corporations, and they took the money." Gardner, *The Tax Consequences of Shareholder Diversions in Close Corporations*, 21 TAX L. REV. 223, 238 (1966).

¹⁴⁹ Consider the problem of deciding whether an arrangement purporting to be a lease of equipment is to be recognized by the tax law as a lease or is to be treated as a conditional sale. One important indicium of a conditional sale is the development by the user of an equity in the asset, and such a development depends in part on the value of the property. The expectations of the parties, at the time of consummating the arrangement, with respect to changes in the value of the asset may therefore be relevant in assessing whether the arrangement was calculated to develop an equity for the user. See *Western Contracting Corp. v. Commissioner*, 271 F.2d 694 (8th Cir. 1959); *Benton v. Commissioner*, 197 F.2d 745 (5th Cir. 1952); Rev. Rul. 540, 1955-2 CUM. BULL. 39; Note, *Federal Income Tax Treatment of Equipment Lease-or-Purchase Agreements*, 52 VA. L. REV. 1336 (1966).

It might be more instructive to ask whether the parties intended the user to develop an equity in the asset than to ask whether the parties intended to enter into a sale rather than a lease.

VIII

A rational tax system needs to consider why motive, intent, and purpose are relevant to accomplishing its aims. As we put our federal income tax to this challenge, some of the points made in this piece may be seen in a slightly different perspective.

The federal tax, as a practical matter, generally has to utilize state law concepts and relationships when doing so is compatible with income tax policies. When the borrowed principles involve references to motive, intent, or purpose, these notions automatically find their way into tax law.

Any net income tax must distinguish between consumption and the expenses of producing income. A leading scholar on income taxation pointed out long ago that "here one finds inescapable the unwelcome criterion of intention. A thoroughly precise and objective distinction is inconceivable. Given items will represent business expense in one instance and merely consumption in another In another instance, moreover, the same items may represent investment in training for earning activity later on."¹⁵⁰ Nevertheless, in making the distinctions between consumption, expense and investment we have a choice among rules ranging from those that stress state of mind considerations to those that rely heavily, if not exclusively, on external factors.

A refined income tax need not subject various receipts to differential rates of tax. It may, however, choose to do so. If differentiations are based on the reason (or reasons) why a transferor gave something of value to the taxpayer, or why a taxpayer held an asset on which he experienced a gain or loss, the classification cannot avoid inquiring into state of mind.

Finally, in some areas, particularly those relating to the treatment of artificial entities and their owners, it may be expedient to adopt tax rules that turn on matters of form. These rules often can most easily be drafted against a background of "normal" ways of doing things; but, as two well-known tax experts have pointed out, "the very breadth of the transactions to which the rules could extend and the mechanical terms in which they are written combine to make [the advantageous forms] . . . a tempting avenue of tax avoidance to persons who were not intended to be the recipients of such a safe-conduct pass."¹⁵¹ We may therefore wish to deny tax advantages where use of particular forms serves no adequate non-tax goals. While purpose is central in distinguishing between acceptable and unacceptable uses of forms, purpose

¹⁵⁰ SIMONS, *PERSONAL INCOME TAXATION* 54 (1938).

¹⁵¹ SURREY & WARREN, *FEDERAL INCOME TAXATION* 1530 (integrated ed. 1960).

here generally can be equated with function. Thus, it is possible largely to ignore state of mind considerations and to rely almost entirely on external factors.

But while there is a difference between tests based on states of mind and tests based on external factors, we have seen that results under the two types of tests are generally not very far apart. Whenever state of mind is relevant, the most important operational question usually concerns the weight that is to be attached to various external factors. And for this reason it is in close or extraordinary cases that state of mind is likely to play a significant role as a standard for decision.